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A Schumpeterian Heterogeneous Agent Model of the Business Cycle — **Frank Schohl**

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A Schumpeterian Heterogeneous Agent Model of the Business Cycle

Frank Schohl

Schumpeter's Market Process Theory of the Business Cycle

Schumpeter's business cycle theory is rooted in chapter 6 of the *Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle* which he published in 1911.[1] This book, which laid the foundations for Schumpeter's scientific work, did not become famous because of its explanation of the trade cycle. Instead, it was Schumpeter's analysis of the market process that was regarded as the most important part of the *Theory*. The point of departure was the traditional notion of an equilibrium economy with goods and money moving in a constant circular flow. Because all of the resources were allocated to their optimal utilization, there was no economic reason to depart from the familiar path. For equilibrium theorists, changes of a given setting could only be triggered by disturbances originating from non-economic events such as wars or natural catastrophes which alter the scarcity conditions of the economy. This would affect relative prices which would force the agents to adapt their plans to the new situation. Once the disturbance had been digested, the economy would assume another stationary state, which would be a stable one because nobody would have a reason to depart from it (Schumpeter 1949b, chap. 1).

The problem with this equilibrium notion was that it was not consistent with economic reality. There was no circular flow continuously reproducing itself, and there were not only passive adaptations to exogenous changes of relative prices, but active competition among industrial corporations which introduced new products and new production processes. To include this form of dynamics into economic theory, Schumpeter introduced the concept of the "pioneering entrepreneur," who breaks away from the equilibrium flow by generating "new combinations" (chap. 2). However, since the equilibrium of an economy is a state in which by definition all assets are employed, neither investment money nor production

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[1]The subsequent exposition is based on a tight selection of Schumpeter's voluminous publications on business cycles which total about 2,500 pages. For a comprehensive evaluation of Schumpeter's work see Oakley (1990). The number of pages was counted by Tichy (1985, p. 3).

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inputs are readily available to the pioneer. Therefore, the pioneer needs support from the banker who creates credit money. This money can be used to extract physical resources from the circular flow by offering higher prices to the suppliers (Schumpeter 1949b, chap. 3).

On the one hand, this procedure creates credit inflation. On the other hand, it enables the pioneer to start a new business. When he finally opens up a new market by offering a new product, he is a monopolist who can charge prices above costs. He starts earning profits from which he starts paying back his credit. The pioneer's profits signal lucrative investment opportunities to potential competitors who enter the market by imitating the pioneer's innovation. This increases supply, exerts pressure on prices, and brings profits down accordingly. The process continues until the innovation has spread across the market, profits have been competed away, and repayment of loans has been completed. Finally, the economy reaches a new equilibrium state in which all of the agents have adapted their plans to the new situation (ibid., chaps. 4 and 5).

By comparison to the literature of his time, which attributed the causes of economic unrest to economically inexplicable exogenous disturbances, Schumpeter's theory of the pioneering entrepreneur provided substantive theoretical progress because it modified equilibrium theory by integrating the trigger of economic dynamics. But, the argument presented so far relates only to a single product market. To trace the economic fluctuations of the whole economy back to this elementary source of market dynamics, several additional steps have to be made. The most important one relates to the timing of pioneering moves. If innovation events occurred randomly, distributed over the entire economy, their disturbance effects would not have the potential of generating up- and downswings of the whole economy, because they would average out. In order to gain enough strength to affect macroeconomic totals, the innovation-imitation events have to be synchronized. Schumpeter offers a set of different economic arguments as to why innovations should occur in a swarmlike fashion. First, once the equilibrium has been disturbed by the pioneers, others may follow more easily, because the level of difficulty is lower if the circular flow has been broken already. Thus, primary innovations always induce a much larger number of secondary follow-up actions. Second, the economic and technological effects of innovations are not restricted to the immediate industry that has been affected in the beginning. Instead, they may spread across related industries as well, which in turn are compelled to react. Third, consumption expenditures of employees, whose income has been financed by credit expansion, affect consumption goods industries. Further, reliable calculations of innovative investments can only be made in equilibrium, when economic parameters are known, which requires them to be constant. This is not the case while innovation-imitation processes are going on. Therefore, entrepreneurs having pioneering ideas during a disequilibrium phase of the economy have to wait until a new equilibrium is established before they can break out again (ibid., chap. 6).

This is the essence of the first version of Schumpeter's business cycle theory that was published in 1911. It was elaborated afterwards in a set of follow-up publications. In 1935, Schumpeter worked out the role of equilibrium in his theory. First, he explicitly specified the circular flow to be a Walrasian equilibrium in which each firm and each household are in equilibrium. Second, he laid particular emphasis on the

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theoretical necessity to start reasoning from a fictitious equilibrium point in order to avoid circularity. Third, he set up the "three-cycle-scheme" which was based on a classification of the innovations according to their economic thrust for generating waves of different lengths. It was made up of Kondratieff waves, Juglar waves, and Kitchin waves having durations of 60 years, 10 years, and 4 years, respectively (Schumpeter 1935).

By 1939, the theory had matured and was published in coherent form in a two-volume treatise (Schumpeter 1939).[2] It included the graphical representation of the three-cycle-scheme which had become famous because it explained the Great Depression as the combined result of three coinciding downswings (Schumpeter 1964, p. 175). The largest part of *Business Cycles* was made up of empirical examinations of American, British, and German time-series on various aspects of cyclical and long-run phenomena, some of which went back as far as 1787 (ibid., chaps. 6–25). Until now, Schumpeter's work has been the second largest empirical examination of the trade cycle. It is exceeded only by the voluminous studies by Burns and Mitchell (1946) which were made at about the same time at the National Bureau of Economic Research (NBER). The uniqueness of Schumpeter's work lies in the attention he paid to the history of industries, the behavior of entrepreneurs, and the emergence of new industries, which are not examined by Burns and Mitchell.[3]

Theoretical Problems and Empirical Drawbacks

Critics have pointed to several theoretical problems and empirical drawbacks of the treatise. It was argued that the distinction between innovators and imitators exaggerated the case because the latter faced similar obstacles and were also required to have a vision about commercially useful projects. It has been suggested that the unreal stereotypes of the innovator and the imitator be replaced by distinguishing "primary innovators" and "derivative innovators" (Redlich 1955). Further, critics asked why such an outstanding person as the pioneering entrepreneur is supposed to wait until imitators have competed his profits away; he should have both the capability and the means of staying ahead of his rivals by continually producing innovations. The regularity of business cycles called for the rhythmical emergence of pioneering moves which was not guaranteed by Schumpeter's equilibrium-state argument (Kuznets 1940). First, the idea that reliable calculations were possible only in equilibrium was countered by pointing out that planning of investment projects does not require the complete price list for the whole economy, but is based only on prices for the necessary input factors. Thus, actual information needs are much smaller and can be met at any point in time (Tichy 1984). Second, since finding buyers for a new product is always risky, there is no systematic reason why the risk of introducing an innovation should be higher out of equilibrium (Rothbarth 1942; Tichy 1984). To the contrary, once aggregate profits have started to rise, the very fact that profits can be made is an incentive for competitive moves. Further, the decline of profits during the slump is also a stimulus for change (Rothbarth 1942).

[2] An abridged version was published by Fels in 1964 (Schumpeter 1964).

[3] See Schumpeter (1939, chaps. 6, 7, and 14) for many examples of technical innovations from a wide range of industries.

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Another group of objections was raised against the Kondratieff-Juglar-Kitchin scheme. It was pointed out that there was no necessary connection between the scheme and the theoretical model (Kuznets 1940; Marschak 1940). One objection was that the notion of equilibrium which plays an essential role for the working of the model gets obscured, because the superimposition of three different waves yields eighteen different types of equilibrium. This is due to the fact that points of rest for shorter waves are located on points of unrest of the longer waves. The theoretical consequences of this are not mentioned in the treatise (Tichy 1984). Another objection was that the regularity of each wave's movement requires the underlying innovations to be of similar economic thrust. But, there is no theoretical reason given in the treatise for why this should be the case (Kuznets 1940). Further, it was emphasized that Schumpeter's voluminous empirical analysis did not provide much support for his theory (ibid.; Lange 1941; Marschak 1940; Rothbarth 1942). He did not present any mathematical decomposition of historical time-series from waves of different types, but merely recorded his own visual impressions of the charts. His failure to follow the articulated methods of time-series analysis, which had just been developed, was strongly criticized (Kuznets 1940). As a consequence, Schumpeter was not been able to verify his assertion of fixed size-proportion for the three waves (Marschak 1940). The only observation which seemed beyond doubt was his demonstration of the Kondratieff waves. But while his critics accepted this to be a historical fact, they pointed out that there had been no satisfactory theory as to why such long swings should recur as a result of an underlying economic mechanism.

An Outline for a Research Program

Focusing only on the deficiencies does not do justice to Schumpeter's work, for Schumpeter himself did not consider his approach to be a complete theory. To the contrary, Schumpeter never tired of stressing that his approach was only an outline for a research program that had to be filled in by followup studies. For instance, in 1933 he criticized the then current practice of the newly founded business-cycle research institutes to focus on aggregative analyses only. Looking at macroeconomic totals was not helpful for the purpose at hand, because aggregates not only blurred historical details but might even provide a wrong picture. Instead, Schumpeter (1933, pp. 265-66) encouraged detailed examinations of the history of industries, which should include single firm studies as well as innovation histories.

Further, Schumpeter (p. 266) warned of the uncritical transference to economics of mathematical methods that were not made for this purpose. He suggested that new mathematical methods be developed instead.[4] Two years later, he described a complete research program, which included detailed examinations of the technical, economic and historical features of the development of modern industries to find out more about the influence of internal and external factors on the shape of the cyclical process. Once again, Schumpeter (1935, pp. 8-9) stressed the importance of the study of single firms, because each firm was an individual "resonator."

[4]In the same year, the Econometric Society was founded with Schumpeter as one of its founding members. For the theme of its journal *Econometrica*, which included a strong focus on business cycle theory, see Frisch (1933, pp. 1-4).

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The strength of the critique raised against the three-cycle-scheme appears to be unjustified, if not even superficial. It does not strike at the heart of Schumpeter's approach because he never declared it to be an economic law. He frequently pointed out that his intention in setting up the scheme was to get a working hypothesis about the economic impacts of innovations on which the empirical research of Kondratieff, Juglar, Kitchin and others differed. Schumpeter (1935, p. 7) never insisted on three different innovation cycles. He had chosen this number simply for practical purposes to simplify the exposition of the theory. Schumpeter (1961, p. 180) plainly admitted that he had not been able to prove the existence of the Kitchin waves, because he did not have the means for a thorough examination. In the preface of the *Business Cycles,* Schumpeter (p. 5) invited his readers to do their own research for which his work could provide nothing more than the springboard.[5]

After publication of *Business Cycles,* Schumpeter continued to stress the advantages that might arise from cooperation between economic historians and theoreticians. He went on publishing essays which were in fact nothing else but outlines for interdisciplinary research programs on the business cycle. For instance, he suggested a classification system for firm-level phenomena. He conducted excellent studies that should be elaborated upon (Schumpeter 1947a, pp. 153–54). He identified issues and problems in order to shape the research process (Schumpeter 1947b, p. 9). He suggested inquiries into the financing of innovations by equity and loans, and the role that the banks played in this process (Schumpeter 1949a, pp. 78–79). Many of his proposals were illustrated by examples from traditional economic theory, which he thought to be irrelevant because they had no grounding in the real world. Again and again, he pointed out the need to examine how individual firms rise and fall and how this dynamic affects the aggregate indicators of an economy (Schumpeter 1947a,b; 1949b; 1951).

But all of his suggestions for future work went unnoticed. One reason was that Schumpeter's theory offered no help for the solution of the economic problems of his time while the theory of Keynes was tailor-made for this purpose. Both its relevance for economic policy and its theoretical compactness explain the victorious advance of Keynesian macroeconomics after World War II. Also, empirical research had not been able to demonstrate the existence of innovation swarms. This was considered to be a refutation of the theory. In today's textbooks on business cycles, Schumpeter's theory is presented only for reasons of completeness or is missing altogether.

Most surprisingly, the Schumpeterian renaissance triggered numerous studies of innovations, firm behavior, and market dynamics, without considering their implications for the advancement of business-cycle theory.[6] Thus, substantive

[5]The term "springboard" is used only in the preface to the German edition.

[6]A convenient way to get an overview of the typical issues of the rapidly growing literature of the Schumpeter renaissance is provided by the conference volumes of the Schumpeter Society and by its journal, *The Journal of Evolutionary Economics.* A typical feature of this literature is that it is strongly dominated by industrial economists, whereas macroeconomic issues play only a minor role. Business-cycle theorists have not joined the Schumpeterian community because the current mainstream of neoclassical real business cycle theory is incompatible with Schumpeterian ideas. Thus, the artificial separation of economics into microeconomics and macroeconomics against which Schumpeter fought all his life continues to prevail.

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attempts to improve Schumpeter's market-process based explanation of industrial fluctuations are still missing. The present article attempts to resurrect this part of Schumpeter's research program. The following section collects evidence from recent research relevant to the purpose at hand. Particular attention will be paid to findings on the economic heterogeneities of the firm and how this relates to the business cycle. Section 3 then presents a formal model that tries to capture the heterogeneity of the agents by employing spread measures, a new class of variable that has not been used in formal business-cycle theory before. In conclusion, it will be argued that the model employs Schumpeter's strategy of disaggregate explanation without being open to the criticisms that have been raised against Schumpeter's approach.

COLLECTING SCATTERED EMPIRICAL EVIDENCE

In the present section, three bodies of literature will be examined in order to collect empirical evidence on the functioning of the market process, which might be of use for Schumpeter's explanation of the business cycle. The first body of literature concerns the innovation problem which has been examined from three different perspectives. The first one is the industrial economic perspective. Industrial economics came into being as a separate branch of economics in the 1950s by doing research into the structure-performance relationship. This approach rested on the implicit assumption that industry market structures were exogenous. In the meantime, scholars have realized that the structure of a market is an endogenous variable that changes systematically over time. From this perspective, the innovation issue is relevant insofar as it determines the development of the market structure via the rates of entry, survival, growth, and exit of firms.[7]

The second is research on innovation having its roots in business economics and relates to a wide range of issues centering around marketing policy, reasons for achieving and maintaining market leadership, and the composition of profitable product portfolios. And, the third is research on innovations and stands strongly in the Schumpeterian tradition. It emerged as a coherent body in 1984 when the newly founded Schumpeter Society held the first of a series of semiannual meetings. The literature of the Schumpeterian renaissance combines the two previously mentioned research paths into a consistent theoretical framework. It has encouraged a great deal of work on the measurement and diffusion of innovations, and their impact on the economic performance of firms, industries, and countries.[8]

Taken in its entirety, the innovation literature has provided important insights into the working of the competitive process. It has been found that markets pass through different developmental stages as they evolve over time. In the birth phase of a market when a new product has been commercially introduced, considerable experimentation takes place to improve the characteristics of the product. Quite frequently, there is more than one early mover in the market because different firms pursue similar ideas. Entry rates are high because the lead of the incumbents

[7]See, for example, Klepper and Simons (1997), Utterback and Suarez (1993), Klepper and Graddy (1990), Gort and Klepper (1982) and the references cited therein.

[8]See, for example, the conference proceedings of the Schumpeter Society meetings, Hanusch (1988), Heertje and Perlman (1990), Scherer and Perlman (1992), Shionoya and Perlman (1994), Helmstädter and Perlman (1996), and Eliasson et al. (1998).

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is not wide and entry barriers are low. As the product matures and the dominant design emerges, the nature of competition changes from product-related to process-related innovations. The compulsion to do so arises from within the market, because once the product meets customers' needs, demand rises rapidly and production has to be increased accordingly.

In the expansionary stage of the market, competition for the better product gradually changes to competition for the lower price, which is both an incentive and a force to shift innovative effort to the production sphere. Suppliers who are not able to compete leave the market. As the number of competitors decreases, price competition stiffens because growth of the incumbents facilitates large-scale production techniques which have the side-effect of functioning as entry barriers. These impede imitative entry by smaller rivals and the market matures to an oligopolistic structure. But this does not necessarily mean that the dynamics of competition fade away in the sense of an approximation to an equilibrium, because entry barriers can be circumvented by product differentiation which alters the markets' boundaries.

By comparison to Schumpeter's time, knowledge of the working of the market process has sharpened substantially. Innovation is not a single outstanding event occurring only at discrete times. Instead, it is an ongoing process affecting products as well as production techniques with an endogenously driven shift of focus toward process innovations. Firms cannot take the liberty of stopping innovation because this runs the risk of falling behind. Further, incumbents cannot prevent their rivals from competing because entry barriers can be sidestepped by product differentiation. Thus, there are both forces and stimuli effective at all times rendering the market process an incessant sequence of competitive moves and countermoves.

What is still missing is the linkage between this industrial-economic research on the dynamics of single markets and the dynamics of the macroeconomic business cycle. But there is not much reason to proceed on the track Schumpeter laid, because innovation research has not provided any clues for the clustering of different primary waves at the same points in time. Neither has there been any evidence for the repeated occurrence of similar wavelengths. Diffusion times have been found to be idiosyncratic properties of the respective markets, depending on peculiar characteristics that are impossible to combine into wave-bundles affecting the whole economy. The shortest diffusion times that have been reliably identified amount to about ten years, suggesting the economy oscillates much slower than it actually does. Innovation research has also found that the economic lifespan of products is competed down in a similar way as prices are forced to decline. This, in turn, would imply an acceleration of industrial fluctuations, which has not been observed.

One may conclude from all this that Schumpeter's explanatory approach does not work, because it has been shown to be not in accordance with the facts. But this would be a hasty judgment. The macroeconomy does fluctuate and this phenomenon is the combined outcome of all businesses in all markets of the economy. Another result might be to say that Schumpeter's idea of bundling innovation waves according to their frequencies and points of inflection is not an appropriate solution to the aggregation problem. Instead, one might examine firms which are nothing else than bundles of market operations, according to another aggregation

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criterion. This might provide another view on the emergence of the business cycle which is still within the frame of Schumpeter's research program. Today, there is not much literature on the cyclical biographies of firms and how their varieties fluctuate, but a few studies exist.

The oldest reference of which the author is aware is a paper by Hultgren (1961) published almost fifty years ago. He collected time-series data for corporate profits from 1920 to 1938, which he evaluated using Burns's and Mitchell's diffusion index. The indicator revealed a regular pattern of the cyclical diversities of corporate earnings: In the upswings of the economy the number of firms experiencing rising profits went up, but never exceeded 80 percent of the sample. During downswings the number decreased accordingly but never fell short of 20 percent.[9] The numbers indicate that at every point in time there is a subset of firms which moves counter to the majority of the sample population. This subset of firms varies by size and economic weight: The longer an upswing prevails the more firms join the dominant movement of the economy. The same happens during the downswing. Firms are switching between the majority subset of declining firms and the minority subset of expanding firms. Thus, as the cycle moves on, the composition of the aggregate changes in a systematic way. The aggregate's turning point reflects the fact that the minority process has become the majority process.

Hultgren's paper, which was first presented at a business cycle conference in 1950, has never been cited and has fallen into oblivion, because mainstream economics at his time was predisposed toward Keynesian macroeconomics and had no theoretical use for cyclical variety changes.[10] Hultgren's method, in a recent article (Schohl 1999a), has been applied to German data and similar patterns have been found for five postwar cycles. Hultgren's findings were also examined by using a set of different economic variables such as sales, gross production values, and profit rates, all of which behaved in a similar way: At each point in time two polar tendencies are coexistent. There is a majority process which controls the aggregate, and there is a minority process moving in the opposite direction. Firms shift between the two subsets in a cascade-like way. There is one cascade of firms moving from the majority subset to the minority subset. That is, firms pass their individual lower or upper turning points while the economy is still going down or up, respectively. The minority subset increases until it becomes the majority subset taking over control of the aggregate. Stated differently, the occurrence of macro-economic turning points is explained by a population process that starts long before the turning points actually happen.

Another piece of empirical evidence that can be utilized to advance Schumpeter's business cycle theory is a phenomenon called "countercyclical profitability spread," which has been observed by authors from various countries (Geroski and Machin 1993; Jeger 1994; Lianos and Droucopoulos 1993; Schmalensee 1989; and Schohl and Ipsen 1990). The term relates to the fact that firms are affected unevenly during the business cycle. This unevenness is most pronounced during downswings when the variance of the profit rates or of its changes goes up and reaches its peak at the recession troughs. It has been shown that the increase is

[9]See the chart in Hultgren (1961, p. 328).

[10]See, for example, the theoretically helpless comments of Hultgren's discussant Friend (1951) in the conference volume.

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caused by a divergence among firms whose profits are declining in a recession and by another group of firms that have passed their individual recession troughs and have started moving up again while the economy is still going down (Schohl 1999b). As has been demonstrated by other authors, the countercyclical spread is caused by a divergence of innovating and non-innovating firms (Geroski and Machin 1993).

Putting together the empirical pieces to the puzzle, the following picture emerges. First, there has never been any evidence for the pooling of innovations at certain points in time nor for the similarity of the diffusion times. Product histories were found to be idiosyncratic entities that could not be usefully combined into groups of innovations having a similar economic thrust in the sense of Schumpeter's Kondratieff–Juglar–Kitchin scheme. Instead, firms are innovative all the time, selling products in all possible developmental stages of their respective lifecycles. Second, as a follow-up effect, the firms' economic biographies, which are nothing more than the combination of the firms' product histories in monetary terms, were found to be idiosyncratic as well. But this does not mean that the firm population of an economy is a structureless mass of dissimilar entities. To the contrary, the economic variety of the agents changes systematically over the cycle. These findings related to the countercyclical spread of the profitability dispersion and to the changing composition of the co- and counter-movements of the firms and the macro-cycle. These variety changes are the outcome of the competitive process and provide the point of departure for a disaggregative explanation of the business cycle in which the economic differences of heterogeneous agents play the crucial role.

THEORETICAL ABSTRACTION: A FORMAL MODEL OF THE BUSINESS CYCLE APPLYING SPREAD MEASURES ONLY

An Equation System Modeling the Mutual Dependence of Spread Variables

To set up a formal model of the business cycle that is capable of capturing both Schumpeter's explanatory approach as well as the empirical observations presented so far, several design decisions have to be made. The first decision concerns the variables of the model. One essential aspect of Schumpeter's explanatory approach is the demonstration that macrodynamics is the unintended outcome of the firms' competitive conduct. Therefore, the variables to be selected for the model should reflect the firms' market operations as well as their market revenues. As has been demonstrated in the previous section, there is empirical evidence on the profitability spread, which varies countercyclically. The spread was measured by using the variance of the annual profitability changes v_{PC}. This variance is suitable for the purpose at hand because it includes both the diversity of the firms' cyclical fates, and their changes over time. Therefore, v_{PC} is specified to be one of the model variables.

The next variable is supposed to capture the diversity of the firms' competitive market operations. As the innovation literature in the previous section shows, Schumpeter's approach of considering the rhythmical occurrence of pioneering innovations is not quite in accordance with the facts, because firms are innovative all the time by varying degrees of intensity. A generic variable that comprises the firms' market operations in their entirety may be called change of market offerings,

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or offer changes (DOC). OC is supposed to include not only Schumpeter's core idea of primary innovation, but also all other forms of competitive actions such as secondary innovations and imitations of any kind. It also includes price changes which are an important parameter of action in the later stages of product life cycles, as well as all other forms of shaping offers that are different from before. This comprehensiveness of OC is a formal requirement, because it is supposed to be the explanatory variable for the annual profitability changes (PC), which is also a catch-all variable including economic gains and losses in their totality.

The last design decision concerns the specification of the equation system which can be used for modeling the mutual dependencies of the firms' market-conduct and market-performance variables. From the basic idea of Schumpeter's theory, it directly follows that equation systems needing an external propulsion for the generation of cycles are not suitable for the purpose at hand. Instead, the essence of Schumpeter's theory can only be met by equation systems which generate oscillations "from within themselves." This criterion requires application of the so-called "conservative systems," which produce non-dampened self-propelling oscillations over time merely from the interaction of the variables involved. The most simple conservative system of equations is the Lotka–Volterra system which is made up of two differential equations for two different variables.

The economic considerations for the specification of the equation system are as follows: If a single firm changes its market offerings, this has an effect on its profit rate, which may increase if the innovation is successful, and may decrease if it is not. For the whole population of firms, this means that there is always a variance of offer changes v_{OC}, because the nature of competition is to do things differently to attract potential customers. If the amount of novelty of market offerings differs among the competitors, e.g., if some agents perform pioneering innovations, the variance of the changes of market offerings goes up. If agents are doing similar things, i.e., if imitation prevails, v_{OC} goes down because the amount of product variety is lower than before.

Since innovations are usually economically successful or unsuccessful to varying degrees, there is always v_{PC} which is associated with the amount of changes of the variance of the offer changes. In formal notation, this consideration is represented by equation 1, in which v_{PC} is positively dependent on the growth rate of the variance of the offer changes (v'_{OC}):

$$v_{pc}(t) = a_1 + b_1 \cdot v'_{oc}(t) \qquad \text{Equation 1}$$

The v_{PC} which has been generated by the above equation, however, affects v_{OC} in a different manner. Firms which have placed new offerings successfully on their respective markets, and have thereby improved their profitability position in relation to their competitors, have no need to proceed with modifications of their offers, because they now start earning money with a new and prosperous product portfolio. These products have left their experimental stage and have moved on to the expansionary phase of the product cycle. The characteristic of this stage is that the main features of the product have emerged. Further modifications are only useful insofar as they gradually continue improvement of its attributes. Therefore, the amounts of offer changes that have widened v_{OC} before, now necessarily have to decrease because the amount of novelty required for economic survival and

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success is smaller than before. This makes up a negative feedback from v_{PC} to v_{OC}: High growth rates v'_{PC} reduce the variance of the offer changes. Equation 2 represents this economic consideration in formal notation:

$$v_{oc}(t) = a_2 - b_2 \cdot v'_{pc}(t) \qquad \text{Equation 2}$$

Equations 1 and 2 constitute a system of Lotka-Volterra differential equations which captures the essence of Schumpeter's business cycle theory. Its solution, which is the circular curve known from other applications of the Lotka-Volterra model, is presented in figure 1.[11] In order to avoid misunderstandings, it has to be stressed that the present application of the Lotka-Volterra equations is based on completely different economic considerations from previous applications of the model in business-cycle theory.[12] The first and most crucial difference is clear from looking at the variables. By comparison to traditional macroeconomic Lotka-Volterra models that employ sum-total aggregates, the present application employs variances. Thus, the focus is on the heterogeneity of the agents, and not on the value totals for the whole economy. The second crucial difference is that the underlying theoretical considerations are based on competitive market behavior, which is captured by a new type of generic variable: the changes of market offerings. These two differences have important consequences for the interpretation of the model. Figure 1 cannot be understood in the traditional macroeconomic way because it requires thinking in terms of varieties and variety changes. How the phase diagram has to be read economically will be worked out in detail in the following section.

Economic Interpretation of Cyclically Interacting Variety Variables

Before the economic interpretation of the model can start, two preparatory thoughts are necessary. The first one concerns the location of the cyclical stages in figure 1, which cannot be deduced by mathematical derivation because the equation system does not contain this information. It has to be taken from the empirical evidence mentioned above, which has revealed that v_{PC} reaches its peak at the recession troughs. From this fact it follows immediately that the lower turning point of the business cycle is located at point B. Furthermore, it follows that point D stands for the peaks, and finally, points A and B represent the middle of the downswings and upswings of the economy. Thus, the course of the business cycle is decomposed into four segments: early and late upswing plus early and late downswing.

The second preparation for the economic interpretation of the spread model concerns how to read the variables on the two axes of the phase diagram. Formally, both model variables are variances, which are evaluated across the changes of individual values of either offers or profitability. If a variance of this kind changes over time, it indicates that the differences of the individual changes have increased or decreased. The economic interpretation of this nested link of two different changes in one variable can best be explained by first considering v_{OC}, which makes up the y-axis in figure 1.

[11] For a much more detailed presentation of the model and its mathematical solution, see Schohl (1999c).

[12] See, for example, the Goodwin model and the related literature (Goodwin 1967).

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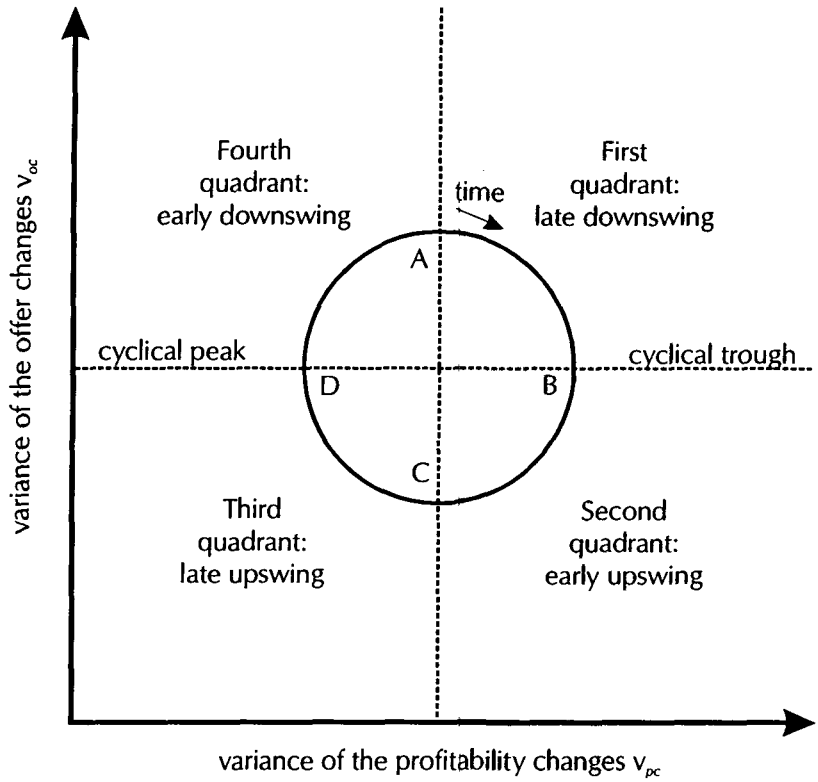

Figure 1
The Working of the Spread Model of the Business Cycle

In order to survive in competitive markets, firms have to be innovative all of the time. Therefore, offer changes are taking place all the time and, as has been explained in the previous section, the idiosyncrasy of the individual changes of supply widens a variance. The existence of a variance simply reflects the fact that Schumpeterian competition is going on. However, the intensity of competitive conduct not only differs across firms—thereby establishing the variance—but it also differs across time—thereby causing the variance to fluctuate. This is due to the fact that each firm can change the intensity of use of its competitive means if management deems it necessary. Thus, changes of the variance of the offer changes v_{OC} over time come about as the combined result of the variety of the individual changes of competitive conduct, which includes all conceivable forms of primary moves as well as all conceivable forms of competitive countermoves.

Two different effects on the variance have to be distinguished. First, if firms change their offers, this provides positive contributions to the variance. As already explained above, the numerical amount of the individual contributions to the variance reflects the degree of novelty that is realized. In any case, current offer changes contribute to an increase of the variance. Second, the effects of past offer changes have to be considered. Firms which have established a new or revised product or have realized any other form of modification of their offerings in the previous period, and do not make any further modifications in the current period,

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do not contribute to the present value of the variance of offer changes because they supply the same product as before. Keeping supply constant results in a decline of contributions to the variance by comparison to the previous year. This, of course, also happens on the markets all the time: There is no need to change a new product which is sold successfully.

Thus, fluctuations of the variance of the offer changes v_{OC} cover the whole set of market actions: changes of supplies contribute spread-shares to the variance thereby raising its value. The decision to stop product changes implies a loss of spread-shares of the respective firms in comparison to the previous period, thereby lowering the value of the variance. The pulsation of the variance which is actually observed in historic time is the combined effect of these two contributing factors. It signals that by comparison to the previous year, one kind of contribution dominates the other one, while both are existent all the time, because the variety of the competitive situations of the individual firms in an economy requires that entrepreneurs apply all sorts of supply-related measures.

Similar mechanics applies to the variance on the x-axis of the phase diagram. The v_{PC} widens if large changes of one subgroup of firms produces positive contributions that overcompensate reductions of the alteration amount of the remaining population. It has to be stressed here that profit rates can also be negative. If a negative profit rate changes negatively, i.e., losses increase, this also enlarges the variance because of the square operation in the variance formula.

After these preparatory remarks, the emergence of the business cycle from the competitive interactions of heterogeneous firms can be explained by walking around the circle of the phase diagram. Let us first consider the upper half circle D-A-B, which stands for the recession. At point A, the variance of the offer changes is at its peak. The reason for this follows from the history before. Because A represents the middle of the downswing, there are many corporations which have already been hit by the early recession. We know from the analysis of the Hultgren indexes mentioned in section 2 that the firm population is not pulled into the downswing simultaneously, but that the number of firms which are hit by the recession increases incrementally. Therefore, while traversing from D to A, the number of firms that are compelled to change their offerings increases in a stepwise mode as well. The contributions of these firms to the variance of the offer changes increase both by number and by amount, thus making up its rise in the early downswing of the macroeconomy.

After passing point A, the variance of the supply changes does not increase further but starts sinking. This is due to the fact that the "early-recession-firms" which have joined into the downswing around D have been working on an improvement of their products since then. These firms have, one after another, finished their innovations and have started selling their improved product offers. If sales increase, it is not useful for this group of firms to make further modifications to their product program, because its renewal has been successful. The contributions of this group of firms to the variance of the offer changes v_{OC} starts to decrease stepwise already between D and A, as the number of firms which have finished their offer changes increases in the course of the recession. Although the overall variance of the supply changes is still increasing between D and A, because of the rising number of firms entering the recession, the countermovement is slowly swelling.

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After passing point A, the countermovement starts to dominate. While the downswing is still moving on and is approaching the cyclical trough at B, there are still corporations entering into the recession, as the Hultgren index has shown in section 2. These "late-recession firms," which are forced to change their offerings are making contributions to the variance of the offer, but as the recession has already endured a fairly long run, most of the firms not only have already been affected by a decline of their sales, but they have even finished the renewal of their product program. Thus, the exits from the variance of the supply changes dominate the entries. This explains the decline of v_{OC} between A and B.

The driving force of the changes of competitive conduct is made up of the changes of profitability, the variety of which is displayed by the second dispersion variable v_{PC}. From the empirical observations presented in the previous section, we know that v_{PC} increases during the downswing. This is due to two opposite tendencies within the firm population. While firms entering the recession have to accept a decline of their profits or even have to suffer from losses, the value distribution widens downwards. At the very same time, however, firms that have innovated successfully can increase their profits, thereby spreading the value distribution upwards. The combined effect of these two opposite drifts makes up the rise of v_{PC} during the the downswing. Or stated in reverse, changes of v_{PC} indicate changes of the frequency distribution of the two divergent effects within the firm population. This inference guides the following analysis of the right half of the figure.

The A-B-C segment of the circle is particularly interesting because it includes the lower turning point. From the previous examination, we know that in the late downswing, i.e., while moving from A to B, v_{OC} goes down because the firms one after another finish modernization of their product program, which results in a reduction of their contributions to v_{OC}. At the same time, v_{PC} widens because these firms, the primary movers on their respective markets, realize extra profits by setting themselves apart from their competitors. However, the counterdrift is also working, coincidentally, because the late-recession entrants suffer from losses which also widen the v_{PC}.

It is important to keep in mind very clearly that both kinds of drift are not made up of homogeneous blocks of identical agents. Instead, the heterogeneity of the firms and the idiosyncrasies of their market positions and market actions result in some sort of staggering. Firms are hit by the recession at different times with different force, and struggle out of their individual crises at different times by applying different measures. This observation sheds a new light on the lower turning point of the business cycle: At point B, two different cascades are interchanging. The first cascade is made up of primary movers which have been hit by the recession early, i.e., somewhere between D and A, one after another, and manage to get out of it somewhere between A and B. This cascade of firms gradually raises its individual sales and increases its production activity correspondingly in a stepwise mode. Thus, the cloud of firms starting up their factories begins to swell in the late downswing.

However, between A and B this upward drift does not yet affect the direction of change of aggregate production of the macroeconomy, which is still continuing its recessionary path. The prevailing macro-state is determined by the second cascade of firms that are suffering from production reductions at this point in time as has been revealed by analyses of the Hultgren indexes mentioned in section 2.

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While this cascade of firms makes up the downward course of the aggregate business cycle because it dominates numerically, its downward drift loses power incrementally because firms which are affected by the recession start improving their offers. If the reversals of competitive conducts of the respective firms prove to be successful on the respective markets some time afterwards, it implies a shift of the respective corporations from the descending to the ascending cascade of firms: the recession gradually fades away. Its end is signaled by traditional aggregative macro-indicators if they change direction. In figure 1, this happens at point B. Thus, the characteristic of the lower turning point of the macroeconomic business cycle is simply that at this point in time the cascade of firms expanding their production overrules the cascade of the depressing firms both by number and by numeric weight.

After passing B, i.e., after the upswing begins, the features of the firm population continue to transform themselves endogenously. While the first movers have already stepped ahead of their competitors between A and B and have widened v_{PC}, they are now followed by the cascade of the second movers. This can be concluded from the y-axis of figure 1, which displays a decline of the innovativeness of the new offers. The character of competition also changes because imitations now gain increasing weight on the markets. This not only reduces the individual firms' respective contributions to v_{OC}, as is displayed on the y-axis, but at the same time results in increasing pressure on price, which subsequently reduces the profitability advantages of the early movers. This makes v_{PC} go down, as the model displays on the x-axis.

It is important to stress once again that changes of the variance always have to be interpreted as changes of the *heterogeneity* of the phenomenon under consideration. Thus, it is not allowable to conclude from the decrease of v_{PC} that innovations no longer occur and that firms start waiting until imitating firms have competed their profits away. As the mere existence of the unceasing business cycle already indicates, market dynamics do not come to a halt. Even while traversing from B to C, primary innovations do occur as they do anywhere in the course of the cycle. The present decline of the variance of the profitability changes v_{PC} only reflects the fact that the cascade of the first movers' profitability advantages, which has widened the variance between A and B, is now narrowed by the cascade of the imitating competitors, which gains increasing weight in the expansionary phase of markets.

While competitive pressure on extra profits continues to rise in the course of the upswing and narrows the variance of the profitability changes, this very same pressure stimulates offer changes in order to escape the decay of profits. The need to do so is of increasing importance for the cascade of the first movers, which has widened the profit variance in the late downswing, i.e., between A and B, and has thereby reversed the course of the macro-cycle. This cascade of firms has been working on changes of its offerings in the meantime, and has placed them on their respective markets at those points in time after B, which appeared to be useful for the respective managements.

As the upswing proceeds, output of finished, capacity-enlarging factory investments increases supplies on the markets causing the share of firms being affected by a decay of their profits to rises, which in turn implies an increasing need to improve offerings. It follows that there has to be a point in time when the cascade

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of imitating product changes is overcompensated by the cascade of newly launched product placements by which early movers try to set themselves apart from their competitors. This is precisely what happens after passing C. While competitive pressure continues to rise due to the cascade of finished, expansionary, investment projects, and thereby narrows the spread of profit rates v_{PC}, the variance of the offer changes v_{OC} slowly starts widening again.

However, the variance of the profitability changes continues to decline between C and D. This is only because increasing rivalry on markets approaching saturation is still the dominant characteristic of this stage of the business cycle. It is the majority phenomenon which generates the course of the traditional macroeconomic aggregative indicators and—the new observation here—also affects the variance. But from this observation, one cannot conclude that all the firms are suffering from a decline of their profitability. This inference is inhibited quite naturally by the fact that we are analyzing the variance and not the mean of the frequency distribution. Therefore, the heterogeneity issue can never move out of the field of view.

Some of those firms that have started offering modified supplies may realize extra revenues immediately, while others may follow at later points in time, because the characteristics of their respective innovation may require some time of diffusion or maturation. Once again, all conceivable forms of idiosyncrasies are present and have to be taken into consideration if the goal of economic analysis is to explain a real-world phenomenon. With the points in time at which the revenues from product innovations start coming in also being a spread phenomenon, the variance of the profitability changes starts increasing when this cascade of market operations has gained enough force to be detected by the variance method of measurement. This happens right after passing point D, at which opposing cascades are changing dominance. Thus, the profitability spread is moving up again, and the variety of the firm population once again has changed its composition endogenously.

SUMMARY AND CONCLUSION

By comparison to Schumpeter's market-process based theory of the business cycle, several features of the spread model have to be highlighted. First, one of the weakest points of Schumpeter's approach was the idea that innovations occur in clusters. In the present article, the conception of the innovation "swarm" has been translated to the "variance." This relaxes Schumpeter's simultaneity assumption. It is not necessary to defer competitive actions until the economy has attained a point of rest. Entrepreneurs who execute changes of their market offers at any time in the real world are allowed to do so in the model as well. They do not have to wait until competitors have caught up. They may also wait or be too slow and fall behind. Or they may even stop competing and change their field of operation. So at any point in time there is a dispersion of different competitive actions, which is reflected in the spread model by using the "variance" notion.

Second, as a followup feature of this modification, the grouping of innovations into different categories of economic thrust is rendered superfluous. The old three-wave scheme is removed completely from the theory. There is no need to decompose the irregular course of a historical time-series into regular components. Instead, the spread-model is based on the idea that macroeconomic time-series are the aggregate outcomes of a multitude of idiosyncratic processes. The only regularity on which the model is based is the empirical fact that there are

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cyclical changes of the agents' economic varieties. From this, it directly follows that the spread model does not rely on the equality of the products' diffusion times and the wave-length of the business cycle. There is no need to link microeconomic and macroeconomic duration variables. Thus, another counterfactual restriction of Schumpeter's approach is eliminated.

Another point of critique that has been raised against Schumpeter's theoretical setup is his reference to the equilibrium notion, which loses its economic meaning if it is applied to superimposing waves. The spread model is not affected by this logical difficulty because it does not require the assumption of a fictitious stable state for the whole economy. Such an assumption may be a helpful device for an unrelated outside observer who needs a point of reference for his analysis. From an entrepreneur's point of view, the situation is different because for him it is more important to know how his relative position is affected by his competitive moves or by competitive attacks of his rivals. The spread model captures the different information requirement by locating each firm's position within the variance of observations and by deriving its dynamics from the positional changes as they are produced by the market process. Thus, the Schumpeterian equilibrium notion has been translated into the firms' relative positions in the value distribution, which provide idiosyncratic points of reference for idiosyncratic competitive moves of idiosyncratic agents.

In this regard, the spread model stands in theoretical contrast to real-business-cycle models that crucially rely on the equilibrium notion. It is the virtue of those models to have demonstrated how the trade cycle phenomenon can be incorporated into equilibrium theory. But this was achieved at the price of heroic and counterfactual assumptions, such as continuous optimization of rationally expecting representative agents. In a world like this, the economic existence of a firm is never endangered by competitive attacks of its rivals because it is removed from RBC theory by applying the representative-firm assumption. By logical necessity, the dynamics of RBC models then have to be imposed from the outside through macroeconomic productivity shocks, the source of which has to remain unexplained. The spread-model avoids all this by permitting the agents to be creative individuals who have to survive in a competitive environment by continually reshaping their market offerings.

Another implication of the spread-model relates to the Keynesian downward spiral, which starts spinning if wage payments are cut back. If consumption expenditures decline, investment goes down accordingly. This further accelerates decline of demand which, in turn, induces additional cutbacks of wages. This spiral chain of effects is afflicted with a typical problem of aggregative reasoning: If all of the subjects of an economy are tied to one single macro-agent, there is no endogenous way to stop the spiral. Within this typical Keynesian macro-logic, only the state can help by injecting artificial demand. The spread-model provides no point of attachment for spiral reasoning because there is no representativity assumption that forces the model agents to behave in a similar way. To the contrary: Individual turning points that were observed in reality to happen at any time during the downswing are permitted in the model in a similar way. Thus, the lower turning point of the aggregate is just that point in time at which the upward forces have gained enough strength to overcompensate the downward forces. Within the spread logic, the turning point is an endogenous phenomenon which is

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generated from within the market system by competitively acting heterogeneous firms. It is not necessary to resort to exogenous factors such as Keynesian state intervention or unexplained RBC technology shocks. The cycle-maker is the market process which generates macroeconomic fluctuations from within the system. In this respect, the spread-model utilizes the explanatory principle of Schumpeter's market-process based theory of the business cycle without adopting its flaws. Future research should be directed to more profound studies of the variety of the agents' competitive moves and countermoves in order to fill the model variable "variance of offer changes v_{OC}" with empirical content. Schumpeter's (1951, p. 155) claim to examine "how firms rise and decline . . . and how this rise and decline affects the aggregates" is still a neglected issue on the profession's research agenda.

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Does Justice Qualify as an Economic Good?: A Böhm-Bawerkian Perspective

Gael J. Campan

One of the most dependable ways of demonstrating the inconsistency of a general principle, theory, or proposition is to deduce some necessarily contradictory consequences from its major premises. In 1849, Gustave de Molinari confronted his fellows at the *Journal Des Economistes*—a bastion of free-market thought—with this Aristotelian truth using a disturbing alternative. Either the *laissez-faire* principle is firmly grounded and thus always applies to the production of every good, and hence must apply to the administration of justice, or this principle is partial and relative, which is to say, it is not a principle at all. Either it is logical and true that the production of security should remain subject, in the interest of the consumers, to the law of free competition, or "the principles on which economic science is based are invalid" (Molinari 1849, p. 280).

Molinari was challenging the premises on which the economic functionality of the state (including the public provision of adjudication) is based. He was addressing the legitimacy of a dichotomy which is still prevalent in economics today.

Indeed, this statement from the first modern libertarian (Hart 1981a,b; 1982; and Hoppe 1989) brilliantly underscores the tension that results from the coexistence of different analytical standards within the same logical framework. Moreover, this seemingly provocative proposition hides a more fundamental question: What is an economic good?

This elementary problem of where to draw the borders of the realm of economic analysis should elicit a common solution within the profession, but it does not. Hence, a restatement of the essential features of what constitutes an economic good may help to clarify some fundamental controversies such as whether markets can provide justice and security. Therefore, this article aims to show that these controversies are rooted in incompatible definitions of a good or, more accurately, of what makes a good an *economic good*.

What is at stake in the definition of an economic good goes well beyond semantics; it goes to the heart of crucial analytical and normative issues. On the

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Gael J. Campan is a fellow researcher at the University of Paris II Assas. An earlier draft of this article was presented at the Ludwig von Mises Institute's 4th Austrian Scholars Conference, April 1998 (Auburn, Alabama). I am indebted to Jeff Tucker for directing me to Böhm-Bawerk's 1881 paper and an anonymous referee for pointing out improvements.

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one hand, the identification of what constitutes an economic good confers on economic propositions their epistemological status and thereafter marks out the field of application of the laws of economics. On the other hand, because of the beneficial normative implications of things identified with the very word *good*, more clearly delineating its meaning may help economists to avoid the temptation of overuse, especially when discussing policy prescriptions.

In 1881, Eugen von Böhm-Bawerk attempted an explicit and extensive answer to this question in his article "Whether Legal Rights and Relationships Are Economic Goods."[1] After presenting Böhm-Bawerk's definition, it will be used as a tool for critically examining some of the core concepts of modern welfare economics, namely the concept of collective goods, external benefits, and transaction costs. Because these arguments are at the forefront of the discussions attempting to justify the public provision of collective services (including adjudication), a critical reappraisal allows a refutation of the orthodox position on a primary, i.e., conceptual, level. Then the position of Böhm-Bawerk will be recast to be more consistent with his underlying theory of goods.

When analyzing the nature of the state and of its agencies for the administration of justice, Böhm-Bawerk abandoned the ironclad standard of a good to which he had been led by his detailed inquiry. Nevertheless, it is argued here that, because he had so firmly established the subjectivist framework of methodological individualism upon which the analytical basis of Austrian market theory rests, his contribution to libertarian political economy generally deserves to be seen in a positive light.

Fundamentals of Economic Goods

This article focuses on the fundamentals of an economic good, drawing upon the 1881 formulation by Böhm-Bawerk. As a guide to the proper method in the quest to characterize an economic good, it might be considered that the purpose of a definition is to distinguish the things subsumed under a single concept from all other things in existence; the defining characteristic must be that essential characteristic which distinguishes them from everything else. Instead of taking for granted an *a priori* definition, this article begins, along with Böhm-Bawerk, with the broadest sense in which ordinary language warrants the use of the term "good." By eliminating irrelevant or vague categories, an attempt is made to discover the discriminating "good-character" in the strictly economic sense.

In its broadest sense, the ordinary linguistic usage includes things that are, to be sure, "goods" but not *means to an end*. These consist mainly of goods which are desired, not as means to achieve ends, but as *ends in themselves*. Böhm-Bawerk (1962, p. 45) delivered an illustrative sample of this category: "Pre-eminent among such things are ethical, religious, and many other kinds of 'spiritual goods', such as virtue, happiness, contentment, peace of mind, and the like."[2]

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[1] Böhm-Bawerk set down, in a fully systematic manner, what is today known as the subjectivist approach of economic analysis.

[2] It is sometimes said that any theory grounded on a logical separation between *means* and *ends* is unrealistic because in practice the two are often amalgamated or fused into one. As demonstrated by Rothbard (1993, p. 66), the only sense to the charge concerns those cases where certain objects or certain courses of action are an end in themselves, as well as means to other ends. Nevertheless, this does not preclude the fact that the separation of ends and means into different *categories* is a logical prerequisite in the analysis of human action in general and of *economizing man* in particular.

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Therefore, economic goods are, as a first distinctive feature, means. At the end of the nineteenth century, this statement was not controversial and writers on economics had seldom been divided as to this basic approach: goods are "those things, which serve human beings *as the means or tools for the attainment of their personal well-being*" (Böhm-Bawerk 1962, p. 39; emphasis in original).

This definition excludes certain things that enter into the causal chain of actions that lead to well-being but must, nevertheless, be barred from identification as an economic good. Those things are, for instance, the superabundant elements of the environment and the invariant qualities of the physical universe. The sun and the air, in most situations, are in unlimited abundance. Hence, they don't have to be allocated to the satisfaction of ends since they are sufficiently abundant for all human requirements. They are consequently not means and are not employed as means to the fulfillment of ends. Though they are indispensable for life, they can not serve as the object of attention of any human actor. It is in this specific sense that they are not means but *general conditions of human action and human welfare* (Rothbard 1993, p. 4).[3]

While scarcity is commonly referred to as an essential feature of an economic good, this must not be understood purely in a physical sense, i.e., a fewer number of items compared to the quantity of others. Indeed, if all means are scarce by definition, it is specifically because they are limited with respect to the actual ends that they are capable of satisfying. If, for some reason, it happens that an end disappears, the good-character of all the things that served exclusively for its achievement disappears, too. Therefore, the characteristics of a good are not inherent in things and not a property of things, but merely a relationship between certain things and men, the things obviously ceasing to be goods with the disappearance of this relationship:

> Whatever importance we accord to the corporeal objects of the world of economic goods derives from the importance we attach to the satisfaction of our wants and the attainment of our purposes. The natural unit of means-of-satisfaction will be the one that corresponds to the means of satisfying one unit of our wants or to the attainment of one unit of our purposes. . . . [whatever] we accord, in the form of *an estimation of value*, to the means to well-being is merely a reflection and a further development of the importance we accord to our *wants* and our *purposes*. Where there is no want and where, rightly or wrongly, there is no approved purpose, there is also no value. (Böhm-Bawerk 1962, pp. 74–75)

One good does not equal another good by its physical characteristics but by the equal serviceability of its units to the actor.[4] Moreover,

> [t]he only reason at all *why men desire corporeal goods lies in the prospect they afford of renditions of service. And these renditions of service are capable of attaining economic independence aside from the goods themselves. Furthermore, this characteristic is not*

[3] See Böhm-Bawerk:

> [It] becomes possible to differentiate corporeal *goods* from nonuseful material things on the ground that *goods are such advantageous manifestations of matter that they permit man to guide the natural forces inherent in them into channels advantageous to him.* (1962, p. 67; emphasis in original)

[4] The term "unit" is not used in a metric sense here.

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> *something that is a purely incidental and secondary matter. On the contrary, it is the renditions of service rather than the goods themselves which, as a matter of principle, constitute the primary basic units of our economic transactions.* And it is only from the renditions of service that the goods, secondarily, derive their own significance. (Böhm-Bawerk 1962, p. 73; emphasis in original)[5]

Then, as a matter of consequence,

> it is not goods, but it is in very truth the renditions of service which emanate from those goods which constitute the smallest independent units of our economy and that the former (i.e., goods) constitute only complexes of the latter, that goods are therefore of secondary category. (p. 77)[6]

One other necessary, although often neglected, prerequisite for being a good is that it must be *known* as a good. Someone must have the knowledge (or at least the presumption) of a causal connection between some characteristics of a thing and the satisfaction of a need (strictly "of an end") for this thing to become a good.

Because knowledge is neither common nor floating in the air, it must be held by someone. Because there is no way to observe this knowledge directly, the ultimate proof for the social scientist that this relevant knowledge rests upon the demonstration of its usefulness through a course of action in which it is involved. Surprisingly, this crucial point has been judged secondary, according to a large part of academic literature.[7]

Also, and more importantly for this study, it is not enough that a thing be known as a potential good to deserve the name of economic good. It is necessary that the thing in question be disposable or available to us. We must possess the full power of disposal over it if we are really to command its power to satisfy our wants. Marvelous plots of land on Jupiter or Venus are *for me* not goods, nor are the things permanently threatened with destruction by natural disasters or spoliation by animals. Indeed, the possession of a good cannot simply be decreed: either you possess effective control over it or not.

At this stage in Böhm-Bawerk's argument, his important point is that other human beings may struggle for control of a good. Thereafter, he raises the issue of the legitimacy of possession, and underscores that: "This legitimate possession is something apart from and in addition to physical possession. And yet, for the attainment of man's *economic* ends, only physical possession, is economically speaking, indispensable" (p. 57; emphasis in original). Therefore, legal enforcement is only complementary to the effective power of disposal, and merely extends the latter in scope:

> [If] legal rights carry economic significance only if and to the extent that they embody physical control, or at least imply a means of acquiring such control, then we are safe in setting down the following conclusions: *in the first place*: (1) Legitimate power of control, however distinct it may be from ordinary physical control (based on possession or

[5]This is what Lancaster will rediscover a few years later.

[6]From this point, Böhm-Bawerk draws the illuminating explanation of the concept of "wearing-out" or exhaustion of goods.

[7]If this statement needs further proof, see, for example, the literature endorsing the perfect knowledge assumption.

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> backed by the owner's power of brute strength), needs to be characterized by a quality akin to the power of physical control and indeed, needs, by its nature to be convertible into physical force; and *in the second place*: (2) This very characteristic (the absence of which reduces all law to impotence, to a desiccated form *sans* content) constitutes the essential quality which endows legitimate rights with economic value, or, indeed with economic character. (Böhm-Bawerk 1962, p. 58; emphasis in original)

So, if legal rights gain their economic significance from the fact that they embody effective control, their content cannot be conceived apart from or in addition to the existing thing concerned: "what is actually being acquired or conveyed is the *things* to which the right of ownership applies" (p. 82; emphasis in original).

At first glance, this may seem an obvious statement, but what we may call the "integration assertion" is an equally cogent refutation of all past and current attempts to introduce artificial cleavage such as those opposing productive and unproductive activities as different economic categories (Hirschleifer 1995). In some modern economic models, the activities focusing on the defense of private property are considered unproductive, whereas by enforcing control, they make (through control) a thing to be a genuine good in the first place: "Legal title to a thing, like the physical possession of it, does not develop outside of, and in addition to the good to which it applies, so as to become a second, independent good. It simply helps to make the thing a good in the first place" (p. 62).

Consequently, there is no separation at all between the enjoyment and the direct control of a thing. In the same way that Böhm-Bawerk integrates the physical thing and its economic qualities,[8] he achieves the integration of the legal right to a thing and of the effective possession of the thing itself, which brings his point to the forefront of the modern debate on the issue of the institutional framework of economic activities.

Last but not least, a crucial point must be set down here, one that was rarely emphasized since the time it was expounded by Böhm-Bawerk:

> [E]very good *can be a good only for those definite economic subjects* with respect to whom every one of the subjective economic "conditions precedent" [those explained above] is fulfilled. Only for those persons who feel or experience the particular want to the satisfaction of which a given thing is adapted; only those persons who are aware of the thing's adaptability; only those who possess the knowledge or skill necessary to use the given thing; and, finally, only those persons who possess the actual power of disposal over the thing—only for these persons is the given thing a good. (p. 43; emphasis in original)

Strictly speaking, then, one should never speak simply of goods as such, but only of goods for Mr. X, Ms. Y or Z, or other specific economic subjects. As it is underscored by Böhm-Bawerk (1962, p. 43), the most important difference here

[8] Böhm-Bawerk writes:

> Once [it] is established, it becomes impossible to maintain, with economic seriousness, that the quality of coldness can be termed a good which exists *in addition* to or more especially *instead of* the cold water, except by indulgence in a pleonasm or a totally impermissible metaphor. (1962, p.118; emphasis in original)

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that comes into play is the difference "between the individual economic subject's point of view and the economic community's point of view."[9]

From a methodological point of view, the value judgment of the observer is irrelevant for identifying the economic preference of another individual. Only one particular individual can experience and recognize as goods the things that are suitable for the satisfaction of his wants. The singularity of the knowledge concerning the multitude of his ends, whether immediate or remote, can only be the object of speculation from the point of view of an external *impartial* observer, whether economist or not.[10] Just as every good must be a good *for something*, so also it must be a good *for somebody*. This last circumstance markedly restricts the area of things that are genuine economic goods.[11]

Let's summarize the essential features selected by Böhm-Bawerk: (1) There must be a human need, or more precisely and less restrictively, a purpose to be achieved. (2) The thing named a *good* must have useful properties, which is not to be understood in a strictly physical sense ("one man's meat is another's poison"). (3) The potential or actual possessor of the good must know these useful properties. (4) This actor must have the ability to utilize the thing: he may know the usefulness of a thing without being able to use it himself. According to Böhm-Bawerk, this condition was lacking in Carl Menger's (1994, p. 52) enumeration. (5) Finally, this individual must possess effective power of disposal over the thing, with special emphasis on the fact that things belonging to someone else are for him not goods.

At first glance, the fourth point may be considered redundant with the fifth, if the concept of effective power of disposal is extended to knowledge, i.e., if the control is not only physical. Nevertheless, Böhm-Bawerk explicitly justifies this distinction in calling the former purely subjective, whereas the latter is considered to be "external."[12]

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[9]For an exhaustive discussion of this topic, see Böhm-Bawerk (1962, pp. 43-45).

[10]Furthermore, agents are given recognition for positive causality, and the relationship between the thing and the individual leaves no place for a determinist interpretation, as is illustrated in the book's example:

> Whatever intellectual element is added we supply out of our "souls" when we react to the physical stimulus. But if we are not prepared for the fruitful reaction—if, that is to say, we cannot read or, even if we can read but are incapable of the necessary understanding or emotions, then nothing takes place beyond the physical stimulus. (Ibid., p. 69)

Beyond the outstanding modernity of this element of cognitive psychology, this assertion is so radical in its formulation and so subversive in its consequences that even Böhm-Bawerk failed to draw all of them. A patent example of this failure is his analysis of the nature of the State.

[11]It is worth noticing, that although many logical restrictions were introduced here in order to mark out the realm of goods relevant for economic analysis, goods are not limited in number. Moreover, even if the logical category is immovable, its concrete elements are always changing. New goods are perpetually created, and as many ends are satisfied, new ends appear to each individual.

[12]For clarification see Böhm-Bawerk:

> "Ability or knowledge of how to use" is lacking in Menger's enumeration of the conditions requisite for goods-quality. I felt that it was necessary to list it as a requirement independent of and different from the factor that Menger lists next under the name of "power of disposal." My reason for this is that the latter is a purely external factor while "ability to use" (or knowledge of how to use) is a purely subjective factor. (Ibid., p. 42, n. 2; emphasis in original)

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After having disencumbered the category of goods from pleonastic and superfluous elements, Böhm-Bawerk provided more than a mere definition. Indeed, Böhm-Bawerk launched, through this definition, both an operational discriminating set of criteria and a genuine subjectivist framework for methodological individualism.

A Critical Reappraisal of Elements of Welfare Economics

In light of this clear-cut set of criteria, some of the most important analytical tools of modern welfare economics hardly appear sustainable. Two traditional concepts, in particular, because of their explicit use of positive connotations, will be subjected to detailed examination: "collective goods" and "positive externalities." The concept of "transaction costs" which is central to the tradition of the law and economics movement and which plays a crucial role in claims for public intervention deserves, in this respect, special attention.

Collective Goods

Collective goods, which often become public goods due to the alleged necessity that they be produced by government, are considered to have special features that other goods do not possess. According to Cowen,

> A public good involves two elements: non-excludability and non-rivalrous consumption. Non-excludability refers to the impossibility of preventing non-paying individuals from enjoying the benefits of a good or service. Non-rivalrous consumption refers to cases in which individuals' ability to consume a good or service is not diminished by allowing additional individuals to consume it. (1988, pp. 3–4)

In light of Böhm-Bawerk's definition, what is to be concluded concerning this traditional notion, beyond its surface of analytical sophistication? Given the explicit necessity of a good being a good for someone, the notion of a collective good would have appeared rather incongruous to Böhm-Bawerk. It was clear to him that a good cannot be a good *per se*, whether collective or not, if it is not deemed to be so by individuals: "[f]or the whole category we are dealing with concerns not the *existence* of goods but only the *connection* of goods with individuals, or it concerns the assignment of reasons for subjective good-qualities" (Böhm-Bawerk 1962, p. 134).

Furthermore, what could non-excludability mean except that the power of disposal over this collective good would be drastically reduced by the impossibility of excluding others from its enjoyment? Obviously enough, it cannot be a good at all if it is defined as uncontrollable.

Non-rivalrous consumption does not seem to be better suited for the characterization of a genuine economic good. Indeed, if its consumption is non-rivalrous, it simply means that it is in unlimited abundance, and, therefore, that it cannot be the object of any human action.[13] Once again, it cannot be a good at all if it is defined as a general condition of human action.[14]

[13] And is there any point in producing, even publicly, a superabundant good?

[14] For the refutation of the "technically collective" argument, see Rothbard (1993, p. 885).

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Unfortunately, even though an orthodox critical appraisal (Brubaker 1975) has attempted to overcome these difficulties, it never goes beyond superficial arguments, stressing that the production of public goods

> results in "forced riding" by individuals who are coerced into expressing non-existent "demands" for collective goods. Or worse a "good" in fact may be a bad, in some views, from which it is economically not feasible for the individual to exclude himself, and for which compensation may be appropriate. (Brubaker 1975, p. 157)

These circumlocutions merely admit that the production of collective goods in no way results in goods production, but instead, in enforced redistribution, i.e., in common language, spoliation.

Positive Externalities or External Benefits

The supposed problem of external benefits is a major justification for governmental activities. Though not directly using the word, Böhm-Bawerk alluded to the concept. A non-controversial definition of external benefits explains the issue as follows: "an externality exists whenever an individual's actions affect the utility of another individual. Positive externalities are those that benefit others" (Cowen 1988, p. 2), and its normative corollary: "Such benefits are not accounted for in the market and a subsidy is required to correct this defect" (Brownstein 1980, p. 93).

A candid Böhm-Bawerkian might raise two questions: Benefits for whom, and a subsidy to be taken from whom and required by which standard? According to Böhm-Bawerk's approach, the only valid problem is the problem of control. Typically, contracts allow the internalization of externalities, since they aim at insuring control of a stream of services, as in the famous example of the beekeeper and the tree grower. For the beekeeper, the presence of the actions of his neighbor are, among many other things, a general condition of his own actions. If he wants to secure his production, making it less dependent upon the whims of his neighbor, he can buy the whole land, or set up a simple agreement with the neighbor to engage in production for several years. In short, he can buy more control over these things. This long-term contract is nothing more than a capital good in the sense identified by Böhm-Bawerk (1962, p. 100), i.e., a good of remote order.[15] In this particular case, it is the contract that (through control) transforms a general condition of action for the beekeeper into the category of genuine economic good.

Nevertheless, another famous line of attack has been advanced by Paul Samuelson, according to whom the existence of externalities annihilates the realm of the private sphere: "What are we left with? . . . With a knife-edge pole of the private good case, and with all the rest of the world in the public good domain by virtue of involving some 'consumption externality'" (Samuelson 1969).

The difficulty with this position is that it proves too much: every action leads to externalities. Indeed, we are all benefactors of others' actions, present and past.

For instance, Rothbard (1993, p. 888) asks, "which one of us would earn anything like our present real income were it not for external benefits that we derive from the actions of others?"

[15]Cheung (1973) demonstrated with an empirical study that real farmers through contract relationships had precisely overcome the impending disaster predicted by welfare economists.

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As a matter of fact, the external benefits argument is double-sided: On the one hand, the recipient is charged with free riding. He doesn't pay for the benefits he gains from the actions of others. The recipient is denounced as a "free rider," a man who wickedly enjoys the "unearned increment" of the productive actions of others. This line of reasoning is a perfect illustration of self-contradictory concepts. Insofar as these words make sense, in order for somebody to give something, he must own the thing, i.e., according to Böhm-Bawerk, have the power of control over it. But externalities are precisely the non-controlled results of one's action. So, in no way can anyone make a gift of them.[16] Furthermore, how can there be such a thing as "compulsory benefaction?"

On the other hand, the benefactor is suspected of underproducing the external benefits that are worth so much to others. Here again, some slight self-criticism can be found, but it is not based on conceptual grounds. Kenneth Goldin (1977, pp. 53–71), for instance, advocates as a source of misconception an unconvincing lack of imagination: "for many years, exclusion from the services of lighthouses and bees was asserted to be impossible, not because it actually was, but because economists lacked the imagination or empirical studies to show otherwise."

Along with Böhm-Bawerk, I would say that they rather lacked a single cogent and unambiguous analytic standard of what constitutes an economic good.

Transaction Costs

The concept of transaction costs is sometimes used in conjunction with the common externality argument in order to argue that neighbors may not coordinate spontaneously because of "high transaction costs." It is a concept which encompasses many different features: "transaction costs are defined as obstacles to market exchanges that interfere with or discourage the process of transacting. In the presence of transaction costs, externalities are often considered a source of market failure" (Cowen 1988, pp. 2–3). Their reduction then becomes an economic imperative. Indeed, "In the absence of transaction costs, externalities are not a source of market failures, because the relevant parties can bargain their way to the optimum" (p. 2).

Let us assume, for the sake of the argument, that transaction costs are barriers to exchange. But, even so, in what sense is an exchange an end in itself? In order for an exchange to take place, each party must consider the thing owned by the other as a "better economic good" than his own. Therefore, the knowledge of the existence and the availability of a good is an imperative condition for this thing to be a good. How could there be frustrated potential exchangers if they are not even aware of the existence of a psychic profit opportunity? Moreover, in what sense can a transaction be satisfactory if it is not voluntary? For whom and by what standard?

We are drawn back to Böhm-Bawerk's emphasis on the difference between the individual point of view and the economic-community point of view.

Regarding the issue of forgone opportunities, this static view of the market underestimates (if not ignores) the central part played by the entrepreneur within the real world. It is precisely because people disagree about what constitutes the

[16]Just as in the famous statement of Proudhon, "Property is theft," the concept of gift, just like the concept of theft, must refer to some definition of property.

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most profitable use of resources that entrepreneurs make profits and become actors in this discovery process called the market.[17] Finally, with collective goods, external benefits, and transaction costs, we have eliminated from the category of goods—groups of things which are as extensive in number as they are ambiguous in their nature.

THE ADMINISTRATION OF JUSTICE: BÖHM-BAWERK'S POSITION REVISITED

The Orthodox Positions According to the Economic Analysis of Justice

Instead of reviewing *seriatim* all the different orthodox positions advocating the *status quo*, i.e., for the public monopoly of justice, the previous discussion suggests that Böhm-Bawerk's definition can be used as a powerful lever that allows for a radical refutation of these approaches, from a conceptual standpoint. As a matter of fact, most of these positions are encompassed in general theories of the state, which seldom address the administration of justice *per se*. These arguments range from, on the one hand, a mere repetition of principle[18] and arguments from intimidation[19] to, on the other hand, highly sophisticated mathematical models arguing the instability or the non-viability of anarchy (Hirschleifer 1995).

However, all other authors resort systematically to either the transaction-costs argument, the external-benefits argument, or the collective-good argument in order to sustain their claim for the public administration of justice.[20] Consequently, these theories can be and actually are refuted, on the mere basis of conceptual inconsistency: they are unsound because they resort to irrelevant economic categories.

But curiously enough, for the purpose of his study, Böhm-Bawerk did not draw such definitive conclusions from the illuminating standard he established. After exposing in the most apodictic way the severely restricted conditions under which a thing can deserve the name *good*, he decreed the government an economic good. He did this using arguments that were in contradiction to results he had obtained from logical inquiry. Despite this aberration, after a brief presentation of Böhm-Bawerk's insights on the institutions of justice, a reappraisal of the subjectivist framework he set down will be offered, from a libertarian perspective.

The Self-contradiction of Böhm-Bawerk

After he had made a thorough examination into the nature of candidates for the status of a good, acknowledging the central role of power of disposal,

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[17]That is what the French etymology of the word reveals: "entrepreneur" literally means in-between-taker.

[18]Douglass North (1981, p. 23; emphasis added):

> the state trades a group of services, which we shall call protection and justice, for revenue. *Since there are economies of scale in providing the services,* total income of the society is higher as a result of an organization specializing in these services than it would be if each individual in the society protected his own property.

[19]James Buchanan (1975, p. 4): "when we examine it carefully, anarchy does not seem to be able to set down the ground principle allowing the organization of social order, even if we stay within the boundaries of strictly interpersonal relationships."

[20]For an exhaustive presentation of these arguments see Landes and Posner (1975, pp. 1–46; 1979, pp. 235–84).

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Böhm-Bawerk addressed the question that is also at the heart of *our* present discussion:

> Only in the rarest instances would the physical strength of any one individual suffice to preserve the physical control that is indispensable for the preservation of his economic requirements against the attacks of other individuals and especially against the wishes of the community. In this connection, therefore, the power of disposal and control which relies on individual physical strength, must seek outside assistance.... And that assistance is effected through the administration of justice. That administration proceeds along the following lines: The first step consists in a ruling by the court as to whether or not the necessary presuppositions are in force, by virtue of which the instrumentalities of the community may be invoked; then the enforcement agencies of the state lend their physical support to the community-member entitled thereto, in order to place him or maintain him in the position of factual physical control of the thing in question....
>
> Hence a legal right or the legalized power of disposal over a thing is nothing more nor less than a necessary re-enforcement supplied by a politically organized state of the physical power which is needed by the owner of a good as a condition of its economic utilization. (Böhm-Bawerk 1962, pp. 58–59)

Thus, the economic function of legal rights and of their enforcement closely parallels that of physical possession of a good. Both identify a species of the power of disposal and, in combination with each other, they constitute the complementary constituents of complete economic control.

Note that Böhm-Bawerk gives a functional definition of the "agencies of state" which leaves space for various institutional arrangements. But then, he anticipates the modern professional opinion:

> Under the economic conditions prevailing in our society, the desired complete and assured power of disposal over goods is, so to speak, divided between two agencies. The first is the strength of the individual, the second is the power of the state as represented by its agencies for the administration of justice. The natural power of disposal possessed by any individual economizing subject would be inadequate. For it would *probably* be at a disadvantage against the unlawful attacks of other individuals. (Ibid.; emphasis added)

In fact, he further describes the government as a public-good phenomenon, anticipating the free-rider argument, considering that "only a very tiny fraction of the total advantage derived from the state's institutions impresses itself upon any individual as a direct and positive rendition of service" (ibid., p. 132).

What of the criteria of being known as a good, being under actual control, and mostly, being perceived mostly as a subjective good? These traits are not to be found in the government provision of justice; can his own theory of what constitutes a good be used to establish that these traits subsist in such government provided "goods?" The compelling evidence is that of a typical *ad hoc* argument. Although it is a realistic, non-holistic theory of the state, inner contradiction is obvious and inescapable.

Böhm-Bawerk as an Inadvertent Contributor to Libertarian Theory?

Apart from Böhm-Bawerk's surprising backward leap, it seems unfair to classify him among those who make the usual claims for the provision of public justice by

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the state. First, while he suggests that the government should play a role in social organization, his description of the state is still highly minimalist. As a matter of fact, he describes the state as a functional complex of resources aiming exclusively at achieving the protection of property rights, i.e., the administration of justice.

Second, Böhm-Bawerk's (1962, p. 132) theory and definition of economic goods sets up, incidentally, an entire subjectivist framework of methodological individualism. In the same way that, in the theory of rights, "voluntariness and purposiveness," are the generic features that characterize all action (Philon1979, pp. 1171–96), Böhm-Bawerk's five conditions identify the generic features that characterize all subjects of economic analysis. Further, they do so in a visionary way, expounding in the context of legal-rights analysis and proposing a unified system of thought that integrates the economic, legal, and institutional aspects of economic analysis. In retrospect, this system is astonishingly similar, from the analytic point of view, to the one which gives libertarianism its outstanding analytical power.

From the perspective of history of thought, this singularity should qualify him as an early contributor (although an inadvertent one) to the political economy of libertarianism.

In conclusion, Böhm-Bawerk unerringly centered his analysis on some of the most basic problems in the theory of economic goods. The prerequisites he formulated and drew together constitute a dazzling achievement and a cornerstone for Austrian economic analysis, mostly because they provided a case of universal principle and not of degree. Building upon Menger's foundation, he established an epistemological guideline, that may be called, retaining the analogy with the theory of rights (Philon 1979), a "principle of generic consistency." From a methodological standpoint, the essential implication is that the knowledge that something is a good must be demonstrated: not only must preferences be demonstrated, but the very character of something being a good must itself be demonstrated.

Although this sounds moderate and reasonable, it appears that most mainstream policy prescriptions (like public provision of collective services), when subjected to the Böhm-Bawerkian criteria, do not withstand analysis. Hence, the alternative that Gustave de Molinari stressed in 1849 is still revelent today, and the challenge is the same: either economists must approach their discipline as a coherent, integrated whole, so that such basic concepts as what constitutes a good may be readily understood, or it will grow increasingly fragmented, broken into pieces of unintegrated analysis.

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THE PLACE OF MISES'S *HUMAN ACTION* IN THE DEVELOPMENT OF MODERN ECONOMIC THOUGHT

JOSEPH T. SALERNO

The core of any system of economic theory is the explanation of how prices are determined. As Mises (1998, p. 235) himself put it, "Economics is mainly concerned with the analysis of the determination of money prices of goods and services exchanged on the market." Thus, the core of *Human Action* is parts three and four (pp. 201–684), entitled, respectively, "Economic Calculation" and "Catallactics or Economics of the Market Society." In these two parts, comprising 484 pages, there is presented for the first time a complete and systematic theory of how actual market prices are determined. Of course, Mises did not create this theory out of whole cloth. In fact, the theory of price elaborated in *Human Action* represents the crowning achievement of the Austrian School of economics. It is the culmination of the approach to price theory originated by Carl Menger in 1871 and developed further by a handful of brilliant economists of the generation intervening between Menger and Mises. These latter included especially Eugen von Böhm-Bawerk, J.B. Clark, Phillip H. Wicksteed, Frank A. Fetter, and Herbert J. Davenport. Unfortunately, for reasons to be explained below, the entire Mengerian approach went into decline after World War I and had lapsed into nearly complete dormancy by the mid-1930s. Mises's outstanding contribution in *Human Action* was to singlehandedly revive this approach and elaborate it into a coherent and systematic theory of price determination.

This article is divided into sections, section 1 describes the development of the Mengerian approach to price theory up until World War I, by which time it had reached the zenith of its international influence. Section 2 describes its amazingly rapid decline and suggests four reasons for it, including two fundamental theoretical

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problems that had not been solved by the first two generations of Mengerians. Mises's solitary struggle to revive the approach, beginning in the mid-1930s and culminating with the publication of *Human Action* in 1949 is the topic of Section 3. A revisionist thesis is also proposed in this section that disputes the conventional view that Austrian economics was riding high in the mid-1930s when it was suddenly and tragically buried by the "Keynesian avalanche."

THE MENGERIAN TRADITION BEFORE WORLD WAR I

To appreciate the full significance of Mises's contribution, it is necessary to broadly review the course of development of pure economic theory from the early 1870s through the 1930s. Three disparate approaches to price theory emerged out of the marginalist revolution of the 1870s. Léon Walras attempted to explain price formation along the lines of astronomy and classical mechanics, explicitly conceiving of "the state of the market as a general problem of static equilibrium described by a system of equations" (Ingrao and Israel 1990, p. 92). Walras's general-equilibrium approach, while admittedly systematic, was timeless and mechanical and thus incapable of producing a theory of the real-world pricing process, i.e., of the actual, and necessary disequilibrium, money prices generated by the historical market process. In contrast, the partial-equilibrium approach devised by Alfred Marshall involved a misguided attempt to secure realism in economic theory by shunning analysis of the ultimate causes of price and cost phenomena in terms of consumer choices, adopting instead the classical economists' superficial focus on the businessman. This approach, far from securing a greater realism, led to an analysis of the determination of individual prices in isolation, which ignored or downplayed the general interdependency existing among all values and prices in the real-world economy.

Menger's approach differed sharply from both Walras's and Marshall's. It was at once systematic and realistic. As he boldly declared in the Preface to his *Principles*,

> I have devoted special attention to the investigation of the causal connections between economic phenomena involving products and the corresponding agents of production, not only for the purpose of establishing a price theory based upon reality and placing all price phenomena (including interest, wages, ground rent, etc.) together under one unified point of view, but also because of the insights we thereby gain into many other economic processes heretofore completely misunderstood. (Menger 1981, p. 49)

Consistent with his pursuit of an all-encompassing, reality-based price theory, Menger sought to explain "the quantities of goods actually exchanged" (p. 191). He thus focused his explanation on the momentary exchange equilibria, or what he called "points of rest," which coincided with the emergence of historical market prices (p. 188). While Menger thus eschewed mechanical general-equilibrium analysis because it was incapable of yielding a causal explanation of the determination of real prices, he did not fail to present a systematic explication of the pricing process. Thus, he began his treatise with the recognition that "All things are subject to the law of cause and effect" (p. 51). And for Menger, the real and ultimate cause of all value and price phenomena was the incontrovertible fact of the universal human striving for want satisfaction. This striving has as its object the scarce elements of the external world that are perceived as the cause of want

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satisfaction; that is, economic goods. Moreover, since human actors must evaluate the relative importance of satisfying a variety of concrete needs or wants, all economic goods are interrelated in what Menger called "the causal nexus of goods" as complements, substitutes, inputs or products (p. 56). The entire constellation of values and prices is, therefore, a systematic and interdependent outcome of the interaction of individual human valuations and choices.[1]

In the early 1880s, Menger's first followers, Böhm-Bawerk and the latter's friend and brother-in-law, Friedrich von Wieser, began to publish, and, as the decade progressed, the growing stream of publications by them and by others who had been influenced by Menger in Austria and elsewhere increased to a flood. Consequently, by the end of the decade, an identifiable "Austrian School" had coalesced and begun to achieve worldwide renown. It is important to note that even at this early stage, the Austrian School was deeply divided on a crucial issue of basic theory. On the one hand, Böhm-Bawerk fully absorbed Menger's causal-realistic approach to price theory and endeavored to develop it further and apply it to new areas. Wieser, on the other hand, seized narrowly on Menger's "subjectivism" as embodied in the principle of marginal utility and, while usefully elaborating some of the implications of this principle, completely ignored the structure of reality-based price theory that Menger had labored to build upon it. Wieser's purpose was to construct his own peculiar ideal of social welfare based on a state of general equilibrium that he called "natural value," and to link it through the concept of marginal utility to foundations in human psychology.[2] As we shall see below, this split between Menger's earliest and most eminent protégés had momentous consequences for the later development of the Austrian school.

In the three decades from 1884 to 1914, the Austrian School flourished and substantial progress was made in developing the Mengerian approach into a complete theory of price. This progress was embodied especially in the works of Böhm-Bawerk,[3] Wicksteed (1967) in Great Britain, and Clark (1965), Fetter (1915), and Davenport (1968), the core members of the so-called "American Psychological School" in the U.S.[4] The peak of the influence of Mengerian price theory coincided with the publication of the treatises by Wicksteed, Davenport, and Fetter in 1910, 1913, and 1915 respectively. Indeed, as Hayek recounted years later "in the early post-war period the work of the American theorists John Bates Clark, Thomas Nixon Carver, Irving Fisher, Frank Fetter, and Herbert Joseph

[1]For an interpretation of Menger's value and price theory that emphasizes the centrality of the law of cause and effect, see Salerno (1999).

[2]In his first book Wieser characterized economic theory as "applied psychology." Although he eventually came to reject this designation, he continued to maintain that economic investigation began from the "practical consciousness of economic relations," which was the common property of the laymen and the theorist (Wieser 1967, pp. 3–4). For further discussion of the psychological element in Wieser's economics, see Kauder (1965, pp. 120–23). On Wieser's concept of "natural value," see, Wieser (1971, pp. 60–64) and Howey (1989, pp. 151–52).

[3]See Böhm-Bawerk (1886, pp. 1–82, 477–541). This long journal article, never translated into English, was actually a monograph on value and price theory most—but by no means all—of which was incorporated into the German-language edition of his *Positive Theory of Capital* published three years later. See idem (1959, vol. 2, pp. 121–56).

[4]The term "American Psychological School" was coined by Fetter to designate his own doctrines. It was intended to emphasize the scrapping of the last vestiges of Benthamite hedonism in favor of volitional psychology as the basis of Mengerian value theory (Dorfman 1969, pp. 361–62, 385).

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Davenport was more familiar to us in Vienna than that of any foreign economists except perhaps the Swedes."[5]

THE DECLINE OF THE MENGERIAN TRADITION

Unfortunately, the Austrian School and its causal-realistic method declined swiftly from the acme of its international influence. There were four basic causes of this decline. The first involved events that occurred in Vienna in the decade leading up to World War I. These included, most importantly, the premature wilting of Böhm-Bawerk's vital and creative powers, culminating in his untimely demise in 1914 and the concurrent flowering of the creativity and intellectual influence of Joseph A. Schumpeter.[6] The second was the rapid rise of Marshallian economics in Anglophone countries to almost complete dominance in the field of pure theory by the early 1920s. The third factor that served to undermine the Mengerian approach to price theory was the great stimulus given to research in Continental general-equilibrium analysis at the London School of Economics by the arrival of Friedrich A. Hayek in 1931. Finally, the Mengerian approach itself, even in its most sophisticated elaboration in the works of Wicksteed, Fetter, and Davenport, contained important deficiencies that were conducive to the widespread view that it offered nothing more than a less rigorous, verbal rendering of general-equilibrium analysis. Each of these factors will be dealt with in turn in the following four subsections.

The Decline of Böhm-Bawerk and the Rise of Schumpeter

With the publication in 1886 of his monograph, *Grundzüge der Theorie des wirtschaftlichen Güterwerthes*, restating and extending the principles of Mengerian value and price theory,[7] Böhm-Bawerk had attained an international reputation. Following publication of the second volume of his magisterial treatise on *Capital and Interest* (1959) in 1889 and the long-running controversy it almost immediately precipitated, Böhm-Bawerk assumed the mantle of leadership of the Austrian School from Menger. Except for two brilliant articles on capital and on money, published in 1888 and 1892,[8] respectively, the latter had made no substantive contributions to

[5]See Hayek (1992, p. 32). It is puzzling that Hayek would attribute this development mainly to the seemingly trivial circumstance that Schumpeter was an Austrian exchange professor at Harvard in 1913. It is more likely that it was Böhm-Bawerk who drew the attention of his Austrian colleagues and students to these American thinkers well before 1913, since his numerous interchanges with them in American journals reveal his familiarity with and respect for their works. This interpretation is consistent with Mises's statement that "I know how much I owe to the economists of [the U. S.] in particular since the time, many years ago, when my teacher Böhm-Bawerk directed my attention to the study of the works of John Bates Clark, Frank A. Fetter, and other American scholars" (Mises 1980, p. 224).

[6]I am indebted to Jörg Guido Hülsmann for alerting me to the crucial, but heretofore neglected, role of Schumpeter in the early development of the Austrian School.

[7] The doctrinal significance of Böhm-Bawerk's *Grundzüge* has been recognized by Hennings (1997, p. 12):

> Böhm's monograph on the theory of value, published . . . in the most respected German-language journal, came soon to be recognized as a brilliant statement of some of the core views of the group, and all the more so as Menger's *Grundsätze* was by that time extremely difficult to obtain.

Hayek (1992, vol. 4, p. 112) referred to "Böhm-Bawerk's brilliant exposition" in which he "gave the most complete version of the new doctrine, including the law of costs, the form in which the doctrine was popularized."

[8]The paper on money has been translated into English. See Zlabinger (1977).

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economic theory since the early 1880s and his *Principles* was by then long out of print and extremely difficult to obtain.

Long before Böhm-Bawerk's death in 1914 at the age of sixty-three, events in Austria had begun to take an unfavorable turn for the Mengerian approach. In 1889, Böhm-Bawerk went into government service, where he remained for fifteen years. Although he closely followed the rapidly expanding literature and continued to publish during these years, his duties as a high-level public servant left him little time to spare for scholarly activities. By the time Böhm-Bawerk assumed a specially created chair at the University of Vienna and returned to full-time academic pursuits in 1905, he had attained the status of a venerable elder statesman and could not completely escape continued nonacademic demands on his time and energies. In addition, he was also naturally accorded a statesman's role within the economics profession, he served for many years on the council of the Austrian Economic Association, and was also elected Vice-President and then President of the Austrian Academy of Sciences in 1907 and 1911, respectively. In addition to these heavy demands on his time, his ability to vigorously renew his scientific research was hampered by his enormous workload in the previous fifteen years and the heavy toll it had taken on his health. Thus, upon his return to academic life at the age of fifty-four, he "seemed older than his years suggested." Two years, later he described himself as an "old man."[9]

Meanwhile, during Böhm-Bawerk's debilitating hiatus from academic life, Menger retired from the University of Vienna in 1902 and Wieser acceded to his chair the following year. Wieser was a diffuse and idiosyncratic thinker and, as noted above, inclined to follow the Walrasian general-equilibrium approach to price theory. Although his primary doctrinal influence was admittedly Menger, he certainly could not be classified as a Mengerian price theorist in the same sense as Böhm-Bawerk or even Wicksteed and Fetter. As his university student, Schumpeter, wrote of him:

> Any professional colleague who penetrates Wieser's intellectual universe is at once aware of a new atmosphere. It is as though one had stepped into a house that bears no resemblance to others' houses one knows, whose organization and furnishings are alien to our era and at first disconcerting. . . . Rarely has an author owed as little to other authors as Wieser. At bottom his only indebtedness is to Menger, and all that he owes Menger is the initial impetus. . . . With sovereign calm he waves aside what other specialists have written when he creates his own work. . . . He reads neither rapidly nor extensively and rarely seeks to grasp the finer points of other people's intellectual systems.[10]

Mises expressed considerably less enthusiasm for Wieser's intellectual abilities and achievements than Schumpeter, but also contended that Wieser's work did not owe much beyond initial inspiration to Menger. While conceding that Wieser recognized the significance of Menger's work "immediately" and "enriched the thought in

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[9]This paragraph is based on Hennings (1997, pp. 12–17). Mises, who attended Böhm-Bawerk's famous seminar at the University regularly between 1905 and 1913, observed that, in this period "Böhm-Bawerk could have produced much more if conditions had permitted it. . . . But his physical constitution could no longer stand the hard work necessary to embark upon great works—his nerves were failing him. The two-hour seminar already taxed his strength" (Mises 1978, p. 41).

[10]Schumpeter quoted in Hayek (1992, p. 120). Hayek wrote similarly that "after the initial stimulus received from Menger, [Wieser] very much pursued his own ways" (p. 49).

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some respects," Mises denied that Wieser was a "creative thinker" and believed he was generally "more harmful than useful." In fact, according to Mises, Wieser

> never really understood the gist of the idea of Subjectivism in the Austrian School of thought, which limitation caused him to make many unfortunate mistakes.... His ideas on value calculation justify the conclusion that he could not be called a member of the Austrian School, but rather was a member of the Lausanne School. (Mises 1978, p. 36)

On the latter point, George Stigler's judgment echoed Mises's. Stigler (1949, p. 158) stated that Wieser's theory of imputation "is much more closely allied to the earlier writings of Walras than to those of Menger and Böhm-Bawerk."

Schumpeter entered the University of Vienna in 1901 and began to study economics in 1903 under Wieser, then newly ensconced in Menger's former chair. The fateful meeting of these two men as teacher and pupil marks the beginning of the downfall of the Mengerian approach to price theory in Austria itself. Schumpeter was "deeply influenced" by Wieser, and "their ideas on many topics in economic theory bear great similarity" (Allen 1994, p. 37). And while it is also true that Schumpeter (1969, p. 143–90) participated in Böhm-Bawerk's famous seminar in 1905 and 1906 and later eulogized him in glowing terms as his great teacher and master, Schumpeter himself identified Walras and Wieser in his first book as "the two authors to whom [he] felt closest affinity" (Machlup 1978, p. 462). This book, *Das Wesen und der Hauptinhalt der Theoretischen Nationalökonomie* (*The Nature and Essence of Theoretical Economics*), was published in 1908 and was an attempt to explain and defend the use of the model, or "schema" as Schumpeter called it, of the "static economy"—wherein all economic quantities subsist in changeless, mutually-determined general equilibrium—as the main tool of pure economic analysis. Significantly, it was also in this book that Schumpeter originated the concept of "methodological individualism," which was to become so closely identified with the Austrian School of economics (Swedberg 1991, p. 26).

Das Wesen immediately propelled Schumpeter to the front ranks of economic theorists on the Continent and established him as the preeminent member of the third generation of the Austrian School. Wieser accorded the book a long and respectful review, which, in parts, was highly laudatory. Wieser's main objection was the misguided one that Schumpeter rejected the use of "psychology" as a foundation for marginal utility theory.[11] Nonetheless, Wieser viewed the book as the achievement of a first-rate, if precocious, mind. Thus, Wieser wrote that

> One recognizes everywhere the richly and variedly trained mind which is open to all intellectual currents of the time.... [Schumpeter] who only got started a few years ago, may claim with justifiable pride that this book has not been written for beginners but presupposes a fairly detailed knowledge of the state of our science. (Quoted in Allen 1994, pp. 83–84)

Walras, also, was favorably impressed by the book, writing to a colleague that the book was a "very handsome and important work" (quoted in Swedberg 1991, p. 30). In the U.S., Clark, by this time the *doyen* of American economists, favorably reviewed the book for the *Political Science Quarterly*, concluding that "This work is

[11] But Wieser did not object to Schumpeter's Walrasian general-equilibrium approach *per se*. As Stolper (1994, p. 9) put it, "Wieser had different methodological opinions from Schumpeter about the need of psychological assumptions in equilibrium theory."

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both critical and constructive, and in each direction it contributes greatly to the progress of economic science" (quoted in Allen 1994, p. 84).

In contrast to his eminent contemporaries, Böhm-Bawerk did not have anything good to say about *Das Wesen*, because he correctly perceived how profoundly anti-Mengerian its theoretical method was. Yet, he too evidently considered Schumpeter an outstanding economic theorist. In a typically penetrating footnote, Böhm-Bawerk provided a devastating critique of Schumpeter's egregious attempt in *Das Wesen* to extirpate the concepts of "causation" and "explanation" from economic theory and to replace them with the concepts of "function" and "description," respectively (Böhm-Bawerk 1959, vol. 3, pp. 228–29). However, Böhm-Bawerk softened his critique by concluding with a playful reference to "an eminent economic theorist" who "allow[ed] himself to be misled because of his use of the mathematical concept of function and consequently being unaware of the dangers of the vicious circle." Indeed, it was largely due to Böhm-Bawerk's intercession that Schumpeter became the youngest full professor at the prestigious University of Graz, and one of the youngest in the Empire, in 1911 at the age of twenty-eight (Allen 1994, pp. 101–02, 117–22; Stolper 1994, p. 6).

Böhm-Bawerk's strangely ambivalent attitude toward Schumpeter—his contempt for his work but esteem for his abilities—is starkly revealed in letters that he wrote to Knut Wicksell. In a letter dated July 9, 1912, Böhm-Bawerk wrote:

> Schumpeter is also very young. And of course he neither [sic] could possibly have been able to master the gigantic undertaking [*Das Wesen*] that he has ventured to tackle. But I consider him to be very talented. About his next, second book (*Theorie der wirtschaftlichen Entwicklung*, 1912[12]) you will probably be shocked even more. He has developed his theory of interest, which I consider to be totally wrong. (Hennings 1997, p. 269)

In fact, Böhm-Bawerk penned a bitter sixty-page critique of Schumpeter's interest theory and, after a forty-page reply by Schumpeter, renewed the attack in a twenty-page rejoinder (Swedberg 1991, p. 39). In a letter written in April 1913, Böhm-Bawerk alluded to "the clever but insubstantial fantasies of Schumpeter" (Hennings 1997, p. 272). But in correspondence a few months later, in September 1913, Böhm-Bawerk was again singing the praises of Schumpeter's talents while dismissing his work as superficial: "With our young economists I am also not in agreement. Schumpeter I consider to be the most gifted among them; and if he could find the way from his present cursoriness to solid and meticulous research he could, with his abilities, make important contributions to science" (p. 273).

It is instructive at this point to contrast Böhm-Bawerk's treatment of Schumpeter with that received by Mises in these letters to Wicksell. Whereas Schumpeter is affectionately portrayed as a brilliant, if rambunctious and willful, *enfant terrible*, Böhm-Bawerk's references to Mises do not betray the slightest degree of personal regard or appreciation for his abilities, despite the fact that Mises had been a regular participant in his seminar for seven years. For example, in a letter dated August 12, 1912, Böhm-Bawerk requested that Wicksell write a review of Mises's *The Theory of Money and Credit*, remarking:

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[12]Translated into English as Joseph A. Schumpeter, *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle* (1969).

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> You have probably also recently received a book on the theory of money by a young Viennese scholar, Dr. von Mises. Mises is a student of myself and Prof. Wieser, which, however, does not mean I would want to take responsibility for all his views. I have just begun to read his book myself, and am not yet familiar with its content. (Hennings 1997, p. 270)

Similarly, in the three subsequent letters written over the next twenty months in which Böhm-Bawerk referred to Wicksell's review of Mises's book, there is not a positive word conveyed concerning Mises's contributions or abilities (Hennings 1997, pp. 271, 274, 275). From this, it must be concluded that even Böhm-Bawerk, despite his profound objections to Schumpeter's approach to price theory, considered him far and away the most promising of the third generation of Austrian economists.

While Schumpeter was being proclaimed by his teachers, Wieser and Böhm-Bawerk, as their most brilliant student and attaining to the status of the youngest full professor in Austria–Hungary, he published his second book, *The Theory of Economic Development* (1969). When this book appeared in 1911, it was greeted with broad acclaim and almost immediately established his reputation among the international community of economists. According to one of his biographers:

> Schumpeter's development book, as he had hoped, made him world famous among serious economists almost overnight. While his first book had alerted the profession to a rising new star, this second one cemented his position as the *wunderkind* of economics and identified him as the most outstanding theorist of social and economic development. (Allen 1994, p. 110)

Schumpeter's reputation spread far and wide. Thus, for example, writing in 1917, the Russian Marxist theoretician, Nicolai Bukharin (1972, p. 56), in his influential critique of Austrian economic theory, characterized Schumpeter as "one of the principal representatives of the Austrian School." By comparison, Bukharin's tone was almost dismissive when referring to Mises in a footnote as "one of the latest advocates of the Austrian School" and a "specialist in the theory of money" (p. 198, n. 100).

The decade leading up to World War I thus represented the watershed decade for the Austrian School in the nation of its birth. A physically debilitated Böhm-Bawerk, although still an influential teacher, was no longer able to undertake original work in pure theory, while Menger had already retired from active teaching and publishing in 1903. In this situation, the publication of Schumpeter's two books sparked a powerful movement to recast the price-theoretic core of Austrian economics along the lines of (verbal) Walrasian general-equilibrium analysis. The publication of Wieser's *Theorie der gesellschaftlichen Wirtschaft* in 1914 added momentum to this movement. Since Wieser's book, later translated into English as *Social Economics* (1967), was the first comprehensive treatise on economics produced by the Austrian School, this meant that the field of pure theory was now almost completely dominated by the general-equilibrium wing of the school.

The momentous result of this state of affairs was that when the fourth generation of the Austrian School entered the University of Vienna immediately after World War I, it was inevitable that its members would cut their theoretical teeth on the works of Wieser and Schumpeter. Wieser was, in Hayek's words, the "grand-seigneur" of

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the school and the most influential economics professor at the university, teaching the main economics theory sequence until 1922, although he continued to lecture as an honorary professor until 1925 (Hayek 1992, pp. 22, 123–24). Wieser, of course, was Hayek's "revered teacher," and Hayek always considered himself an adherent of the "Wieser tradition" rather than the Böhm-Bawerk (and Mises) tradition.[13] But Wieser was also Machlup's "first major teacher" and Machlup took his yearlong theory course twice (Ebeling and Salerno 1980, p. 1). Haberler, too, took Wieser's course and later studied with Wieser's follower, Hans Mayer, who acceded to Wieser's chair in 1922.[14]

Since Wieser's theory lectures followed *Social Economics* very closely—he either "read from" the book or "knew it more or less by heart" (Ebeling and Salerno 1979, p. 1; Hayek 1992, p. 22) it was not surprising that members of the fourth generation considered Wieser's treatise the major theoretical expression of the Austrian School. According to Hayek, writing in 1926: "*Theorie der gesellschaftlichen Wirtschaft* offers not only the sole consistent treatment of economic theory produced by the modern subjectivist school, but it also constitutes, above all, what may well be the greatest synthesis achieved by economic theory in our time" (p. 119). In 1927, Hayek's fellow student, Oskar Morgenstern, effusively hailed the book as "a work that has become the most important statement of the Austrian theory" and "the greatest systematic treatise that has been written by an Austrian in which the principle of marginal utility is analyzed in all its ramifications." Morgenstern (1976a, pp. 482–83) also characterized it as "one of those universally interesting books which mark an epoch in the development of economic theory."

As important as Wieser's treatise was in their formative years, however, Schumpeter's first book, *Das Wesen*, in which he defended the general-equilibrium model as the core concept of pure economic theory, appears to have had an even greater influence on the budding economic theorists of the fourth generation. Writing in 1980, Hayek referred to "his brilliant first book" and argued that the ideas in this work are "certainly essential enough to the understanding of the development of economic theory. Indeed Schumpeter made a contribution to the tradition of the Austrian School which is sufficiently original to be made available to a wider public" (Hayek 1962, p. 161). Hayek also revealed that, "Of course [Schumpeter's] two prewar books and his essay on money were familiar to all of us [of the fourth generation]" (p. 34). Speaking of *Das Wesen* and its great influence on the fourth generation, Morgenstern (1976b, p. 490) recollected that

> The work was read avidly in Vienna even long after the World War I, and its youthful freshness and vigor appealed to the young students. I myself remember what sort of revelation it was to me when I first laid hands on it and, like many others of my generation, I resolved to read everything Schumpeter had written and would ever write.

Haberler (1993, p. 22) characterized *Das Wesen* as Schumpeter's "first great book."

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[13] Hayek explicitly distinguished between "the two original branches of the Austrian School," the Böhm-Bawerkian and the Wieserian, and characterized himself as an adherent of the latter branch (Hayek 1983, pp. 17–18; 1992, pp. 108–09, 157). Hayek also spoke of Mises as "continu[ing] the tradition of Böhm-Bawerk" and Hans Mayer as "continu[ing] that of Wieser" (p. 51).

[14] Ebeling and Salerno (1979, p. 1). Oddly, while Haberler remembered Wieser as "a fine lecturer," Machlup described Wieser's lectures as "terribly dull" and confessed that "it was hard to keep one's mind on the subject," which was why he repeated the course the next year.

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Machlup, also, was greatly impressed by Schumpeter. He lamented that Schumpeter was "unjustly" excluded from membership in the Austrian School, "because of his admiration for the mathematical school of Lausanne" (Machlup 1981, p. 21). In fact, he embraced the Schumpeterian vision of the purpose and method of pure theory. In an article surveying Schumpeter's economic methodology, which frequently and approvingly cited *Das Wesen*, Machlup (1978, p. 462) attributed to Schumpeter a "superior understanding of general epistemology and scientific method." In his own voluminous writings on methodology, it is clear that Machlup adopted the position of "methodological tolerance" that he ascribed to Schumpeter in this article (p. 463). This position boiled down to two claims: first, that the full explanation of a complex economic reality requires historical and statistical as well as theoretical analysis; but, second, in Machlup's words (p. 466), "it is economic *theory*, which in its 'schemas' or 'models' and in its 'theorems' defines and describes (or constructs) the relevant relationships."[15] While such partial-equilibrium and general-equilibrium models are indeed arbitrary constructions and logically anterior to the facts of reality, they are not mere "aprioristic speculations," because they are "designed with the facts in mind." In Machlup's view, the "decisive point" of Schumpeter's methodological position is summed up in the following statement by Schumpeter: "On the one hand our theory is in essence *arbitrary*, and on this is based its system, its rigor, and its exactness; on the other hand, it *fits* the phenomena and is *conditioned* by them, and this alone gives it content and significance" (p. 467). Needless to say, Machlup's methodological approach, which portrays the formulation of arbitrary models as the central concern of theoretical research, describes a major departure from the causal-realistic paradigm of Menger.

But what of the tradition of Menger and Böhm-Bawerk during the 1920s: wasn't Menger's *Principles*, after all, still the guiding star of the Austrian School? And wasn't Mises, the longtime student of Böhm-Bawerk, now teaching a university seminar and conducting his own *Privatseminar*? Regarding Menger's direct influence during this period, although he was still alive, he was "more a myth than a reality" to the fourth generation, "particularly since his book had become a great rarity which was practically unobtainable as the copies had even disappeared from the libraries" (Allen 1994, p.22). And although it is true that Mises was a popular lecturer at the university, he lectured as an unsalaried *Privatdozent* and, in the early 1920s, hardly rivaled Wieser in prestige as a teacher or Schumpeter in reputation as a pure theorist. In addition, Mises's university course was an advanced seminar that reflected Mises's research interests, such as the theory of money and credit, and was not focused on value and price theory (Haberler 1981, pp. 50–51). While it is true that Haberler and Machlup both attended Mises's university seminar,

[15]In this passage, the words "schemas" and "models" refer to the terms Schumpeter applied to partial-equilibrium and, especially, general-equilibrium constructions. In the words of a recent biographer, Robert Loring Allen (1994, p. 77):

> For Schumpeter in *Das Wesen* . . . the economic model is the chief expression and operational tool of the economic theorist. He preferred to call it a schema, or sometimes schemata. In his book he employs both partial and general-equilibrium models. . . . The model of which Schumpeter writes primarily, and the focal model of all of Schumpeter's work in static economic theory, is the circular-flow model or the general-equilibrium economy in a stationary state. It was a variation on the model first developed in mathematical form by Walras.

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Hayek never took a formal course from Mises as a university student and never really met him until after he had already received his degree (Haberler 1981, pp. 50–51; Ebeling and Salerno 1980, p. 1).[16]

Mises's exciting and influential *Privatseminar* was even less focused on pure theory, addressing topics of money, business cycles, and economic policy, and often ranging far beyond economics to the philosophy of science and sociology. Moreover, members of the fourth generation were invited to join this seminar only after they had already obtained their doctorates (Haberler 1981, pp. 51; Ebeling and Salerno 1980, p. 1). For these reasons, it is unlikely that the seminar was instrumental in altering the basic approach to economic theory that they had absorbed from Wieser and Schumpeter. And indeed, it is quite apparent in their later works in the 1930s that Machlup, Morgenstern, and Haberler all accepted the model or, in Schumpeterian terms, the "schema" of general equilibrium as the heart of economic theory.

In his early work, from the mid-1920s up to 1933, Hayek, too, viewed general-equilibrium theory as the core of economic theory. In *Monetary Theory and the Trade Cycle*, for instance, which was originally published in German in 1929 as *Geldtheorie und Konjunturtheorie*, Hayek made it clear that a successful business-cycle theory must be logically integrated with the "fundamental propositions" of the "theory of equilibrium." And by equilibrium theory Hayek (1966, pp. 28–29, 42, n. 2) explicitly understood "primarily . . . the modern theory of the general interdependence of all economic quantities, which has been most perfectly expressed by the Lausanne School of theoretical economics." After 1933, it is true, Hayek struggled mightily to "break out of the Walrasian box"[17] by attempting to dynamize general-equilibrium theory by extending it to include within its purview expectations of the future and the division of knowledge among market participants.[18] But even in his most creative work along these lines, "Economics and Knowledge" published in 1937, he still clung to the belief that "the pure logic of choice," which could be represented by the timeless equations of general equilibrium, played a central role in economic theory (Hayek 1972, pp. 33–56). By 1945, with the publication of his famous article, "The Use of Knowledge in Society," Hayek had definitively abandoned the intractable project of dynamizing general-equilibrium theory. Instead he narrowed his focus to the problem of the interpersonal dispersion of knowledge, and, while assuming that real-world prices were always near their general-equilibrium values, argued that "The mere fact that there is one price for any commodity . . . brings about the solution which (it is just conceptually possible) might have been arrived at by one single mind possessing all the information which is in fact dispersed among all the people involved in the process" (p. 86).[19] So Hayek,

[16]As Hayek (1994, pp. 57, 68) recalled, "I only met Mises really after I had taken my degree. . . . I believe that while I was a regular student I only once went to a regular lecture of his, but rather disliked him."

[17]Murray Rothbard (1987, pp. 97–108) used this phrase to describe the attempts of Schumpeter and Alvin Hansen to dynamize their inherently static theoretical systems.

[18]The story of Hayek's—ultimately futile—struggle is well told in Meghnad Desai (1994, pp. 25–50).

[19]For a characterization and critique of the later Hayek and some current Hayekians as "proximal equilibrium" theorists, see Salerno (1993, pp. 127–28; 1994, pp. 116–23).

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like his Vienna-trained cohort, was never able to escape the general-equilibrium framework he learned in his youth.

Of course, no one would deny that Mises heavily influenced the fourth generation of the Austrian School, but he did so mainly as a monetary theorist and political economist. Having published *Theorie des Geldes und der Umlaufsmittel* (*The Theory of Money and Credit*) in 1912, by the time Hayek and company had entered the university, Mises had already established himself as the preeminent monetary theorist of the Austrian School and, arguably, among Continental economists.[20] It was the publication of *Die Gemeinwirtschaft* (*Socialism*), however, "which would make the most profound impression on [the fourth] generation" (Hayek 1992, p. 133). And while it did unquestionably revolutionize the political-economic worldview of Hayek and his cohorts, it did not challenge them on the level of pure theory. It was not until 1928 when Mises began publishing the series of methodological essays that were collected in 1933 in *Grundprobleme der Nationalökonomie* (*Epistemological Problems of Economics*) that Mises began to be recognized as a general theorist and system-builder along the lines of a Schumpeter.[21] However, even in these years, the members of the *Mises-Kreis* could not have comprehended the details of the reconstructed system of Mengerian economic theory that Mises would finally elaborate in his 1940 treatise *Nationalökonomie*.[22]

The Rise of Marshallian Economics

This brings us to the second factor operating to undermine the Mengerian approach to price theory: the rapid rise to ascendancy of Marshallian economics after 1890 in the Anglophone countries. With Böhm-Bawerk's pen silenced and with Wicksteed, a part-time economist with no academic base and with diffuse scholarly interests, Marshallian partial-equilibrium economics swept the field in Great Britain by the 1920s. This left the London School of Economics, under the leadership of Lionel (later Lord) Robbins, as the lone outpost of Austro-Wicksteedian economics in postwar Great Britain.

The economist, William Smart, exemplifies the speed and thoroughgoing nature of the Marshallian conversion of the British economics profession. In 1891, the year after publication of the first edition of Marshall's *Principles*, Smart published a little primer, *An Introduction to the Theory of Value* (1966), which gave English-speaking economists a lucid and highly sympathetic introduction to Austrian value theory. In the second edition, which was published nineteen years later, Smart added an appendix consisting of a summary of his university lectures on "The Theory of Value: The Demand Side" in order to indicate his more mature attitude toward Austrian doctrines. As the title suggests, this appendix purported

[20]Hayek (1992, p. 127) characterized this book as "for many years the most profound and satisfying work on the subject available."

[21]According to Hayek (ibid., p. 147):

> When these essays were first published they marked the transition of the author then mainly known for his theory of money and credit and his critical analysis of socialism from an economist in the narrow sense of the term to a general theorist and philosopher of society.

[22]As Hayek pointed out with respect to *Epistemological Problems*, "economics serves in this volume mainly as an illustration of the problems raised by any theoretical science of society" (ibid., pp. 147–48).

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to show that Austrian value theory only addressed the demand side of price determination. In the Preface to this edition (p. viii), Smart informed his readers that this summary was meant to be studied "along with Book III of the classic which has moulded modern economic thought, Professor Marshall's *Principles*."

In the United States, the growth of the Austro-American School was stunted by the idiosyncratic personality and writing style of Davenport and the deep personal animosity that developed between him and Fetter,[23] and it failed to produce an influential thinker among its second generation of adherents.[24] Consequently, during the 1920s, with Clark, Fetter, and Davenport nearing the end of their illustrious careers and no longer contributing to pure theory, the school's influence on the mainstream of American economics declined precipitously, leaving the field of high theory in the U.S. completely open to Marshallian domination. Thus, the top three best-selling economics textbooks between World War I and the Great Depression were those written by Richard T. Ely (with three collaborators), Frank W. Taussig, and Henry R. Seager, although the prewar treatises by Davenport and Fetter remained in the top eleven (Dorfman 1969, p. 211). Although incorporating some Austrian insights, the Ely et al. and Seager texts expounded straightforward Marshallian price theory, while Taussig built his original theoretical edifice on John Stuart Mill and was perceptively summed up by Joseph Schumpeter as "the American Marshall" (Schumpeter 1969, p. 220; Ely et al. 1928, pp. 143–79; Seager 1908, pp. 81–106; and Taussig 1928, pp. 109–220). Hayek visited the U.S. in 1923 and was stunned and dismayed by the remarkably sudden foundering of the Austro-American School of price theorists. Reflecting back on this early personal encounter with the American economics profession, Hayek wrote:

> I must confess that from my predominantly theoretical interest the first impression of American economics was disappointing. I soon discovered that the great names which were household words to me were regarded as old-fashioned men by my American contemporaries, that work on their lines had moved no further than I knew already. (Hayek 1992, p. 35)

In Germany, the long night of domination by the anti-theoretical German Historical school was coming to an end, but the book that reawakened the theoretical curiosity of German economists after the World War I was neither Marshall's, nor Menger's *Principles,* but Gustav Cassel's *The Theory of Social*

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[23] On Davenport's eccentricities and his relationship with Fetter, see Dorfman (1969, pp. 375–90). In his recently published lectures on the history of economic thought, Lionel Robbins (1998, p. 278) characterizes a book by Davenport as "an eccentric but learned work." The bitter enmity between Davenport and Fetter is evident in their reviews of each other's treatises (Fetter 1916, pp. 550–65; 1916, pp. 596–605; and Davenport 1916, pp. 313–63).

[24] A few of the younger generation of the school went on to write postwar textbooks that carried on the Mengerian tradition. For example, John Roscoe Turner of New York University wrote his dissertation under Fetter at Princeton and also expressed a "deep obligation" to Davenport, his former colleague at Cornell, in the Preface to his book (1919, pp. iii–vi). Arthur L. Faubel was a student of both Fetter's and Turner's, and was also heavily influenced by the "writings and teachings" of Davenport (Faubel 1923, p. v–ix). Perhaps the last textbook in this tradition was written in 1938 by two of Fetter's colleagues at Princeton, Archibald McDonald McIsaac and James Gerald Smith. Although by this time its price theory reflected the widespread influence of the Marshallian Imperfect Competition Revolution, its chapters on distribution theory and economic equilibrium were straightforward Fetterian doctrine (McIsaac and Smith, 1938, pp. 294–391).

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Economy (1932), which offered a verbal rendition of Walrasian price theory.[25] However, in the Romance countries, nascent Mengerian schools were shunted aside by peculiar, indigenous blends of renewed British classicism and moderate German historicism.

In France, the Mengerian approach was eagerly embraced by Paul Leroy-Beaulieu and Maurice Block, the leaders of the French Liberal School. These doctrinal descendants of Jean-Baptiste Say and Frédéric Bastiat considered Menger's causal analysis of price that began from the fact of human wants as the natural development of the French subjective-value tradition initiated by Say (Leroy-Beaulieu 1910, vol. 1, pp. 83–114; vol. 3, pp. 15–94; Block 1897, pp. 129–85). Unhappily, the Liberal School, which had completely dominated French economics from the beginning of the century, began to go into decline in the 1880s as a result of a radical institutional reform in French higher education that established chairs of political economy in all the Law Faculties. University statutes ensured that these chairs would be filled by jurists and lawyers, most of whom were by temperament and training sympathetic to the approach and policy prescriptions of the German Historical School and radically opposed to the deductive method and hardcore laissez-faire policy program of the Liberal School.[26] This outcome was not exactly uncongenial to the French government, which had engineered the institutional coup. Thus, almost overnight, a self-proclaimed "new" school sprang to life under the leadership of Charles Gide and soon became entrenched as the new orthodoxy in French economics. Gide and the new school "economists" were not particularly interested in developing pure theory, preferring to rehash outmoded and previously refuted historicist criticisms of classical economics, while struggling futilely to come up with a moderate synthesis of the two bodies of doctrine. Even as late as 1907, there still did not exist a formal course on economic theory taught by the Law Faculties, despite the fact that they almost completely monopolized the academic teaching of economics. By the end of World War I, the Liberal School had passed into history and with it any chance for a Mengerian renaissance of French economics.[27] By the 1920s, what passed for pure economic theory in France, outside of a small circle of Walrasians, was a weak and unimaginative brew of classical economics and German historicism with some watered-down marginal-utility theory and Marshallian partial-equilibrium analysis poured in for good measure.[28]

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[25]As Mises wrote, "The decade-long neglect of theoretical studies had led to the remarkable result that the German public must look to a foreigner, the Swede Gustav Cassel, for a principled explanation of the problems of economic life" (Mises 1996, p. 52). In a similar vein, Hayek (1992, p. 33) remarked that "[Cassel's] simplified version of Walras brought about a revival of interest in economic theory in Germany."

[26]The Liberal School has had a great but neglected influence on the development of modern economic theory. See Salerno (1988, pp. 113–56).

[27]On the events in France that led to the rise of the "new" school and the undoing of the Liberal School, see Alcouffe (1989, pp. 313–44); Rowe (1892, pp. 62–85); Gide (1907, p. 192–212; 1890, pp. 603–35); and Haney (1949, pp. 846–59).

[28]For an example, see Gide (1924). This work was the leading textbook in France almost from the time of its initial publication in 1883. This translation was based on the twenty-third French edition. James Bonar, an early supporter of Austrian economics in Great Britain, described the orientation of an earlier English translation of Gide's book as "substantially that of the . . . 'Classical School,' if we substitute evolution and social union ('solidarity') for finality and individualism. . . . [T]he theoretical work of the Classical School is in great part the foundation of his own new building" (Bonar 1900, p. iv).

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The Mengerian approach fared a little better in Italy, where there also existed a dominant Liberal School in the Say–Bastiat tradition, which was led by Francesco Ferrara. Liberal economists, especially Augusto Graziani and Ugo Mazzola, early on began to absorb the lessons of Menger and Böhm-Bawerk and, from 1886 to 1890, the "Austrian School was the most influential among Italian economists." In 1890, the year that three marginalists, including Mazzola and the Jevonian Maffeo Pantaleoni assumed joint editorship of the leading Italian economics journal, *Giornale degli Economisti*, "the army of 'marginalist-liberalists'. . . suddenly grew more numerous" (Barucci 1973, pp. 264–65). However, classical economics and moderate German historicism had already taken firm root in Italian economic thought, predisposing most Italian economists toward eclecticism and preventing these early seeds of the Mengerian approach from achieving their full bloom. The muddled character of Italian economic thought after World War I was well summarized by Lewis H. Haney: By the early 1900s, there had emerged in Italy "the dominant historico-liberalistic eclecticism. . . . Soon the Austrian subjectivism was added, with Graziani outstanding. But even the marginal-utility theorists have made some modification, approaching more closely the Classical theories and so making a fusion with the other group less difficult" (Haney 1949, p. 844).[29]

Hayek and the Transformation of Economics at the London School of Economics

By 1930, there remained one seemingly impregnable academic stronghold of Mengerian economics in Europe: the Economics Department of the London School of Economics (LSE) headed by Robbins. But events were already developing elsewhere in Europe that would rapidly and fundamentally transform the character of LSE economics.

In the early 1930s, the Austrian School had begun to melt away in Austria as more attractive prospects abroad or the National Socialist threat of *Anschluss* drove the leading Austrian economists to emigrate to Great Britain (Hayek and Rosenstein-Rodan), the United States (Machlup, Haberler, and Morgenstern), and Switzerland (Mises). Ironically, this great Austrian migration was the third factor contributing to the downfall of the Mengerian tradition, particularly in Great Britain. For it was under Hayek's influence that economists at the LSE, especially John Hicks, began to introduce Walrasian general-equilibrium theory, as reformulated by Pareto, to Anglo–American economists.

Ingrao and Israel perceptively describe Hayek's crucial role in the early development of the Anglo–American version of general-equilibrium theory:

> The problem that fascinated Hayek was the one Walras and Pareto had left unsolved: the possibility of constructing a convincing interpretation of cyclical fluctuations while not only maintaining the central core of equilibrium theory but actually taking it as a starting point. . . . In his London lectures . . . Hayek started precisely from the concept of general market equilibrium and proclaimed its key importance in economic analysis. . . . Although Hayek did not provide any formalization of his theories, his equilibrium theory offered a wealth of suggestions that were to be taken up in the literature of the 1940s and 1950s. The idea of intertemporal equilibrium, which was to be precisely defined in axiomatic terms by Arrow and Debreu, took shape in his writings of the 1920s and

[29] On the development of Italian economic thought during this period, see also Rabbeno (1891, pp. 439–73); Loria (1891, pp. 203–24); and Einaudi (1955, pp. 7–25).

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> 1930s. . . . The best introduction to a more detailed exposition of the content of *Value and Capital* is perhaps Hicks's own outline of the divide that opened at a certain point between his research program and Hayek's. (Ingrao and Israel 1990, pp. 232–34)

Although Hicks had read Pareto before he met Hayek, he affirmed that Hayek's teaching stimulated him to begin "once again, from Pareto." Regarding the line of work that he pursued during the 1930s and that culminated in *Value and Capital*, Hicks (1983, p. 359) revealed that "I did not begin from Keynes; I began from Pareto, and Hayek." Hayek (1992, pp. 53–54) himself regarded the analysis of value theory in *Value and Capital* in terms of marginal rates of substitution and indifference curves as "the ultimate statement of more than half a century's discussion in the tradition of the Austrian School."[30]

More momentous, however, than Hayek's direct impact on Hicks, the idiosyncratic and eclectic theorist, was the profound effect that the Hayek–Hicks collaboration had on Robbins, the very heart and soul of LSE economics. Between 1927 and 1934, Robbins had written a series of brilliant papers elaborating and applying causal-realistic price theory and criticizing Marshallian partial-equilibrium economics.[31] In addition, his *Essay on the Nature and Significance of Economic Science*, first published in 1932, clearly evinced the author's "especial indebtedness" to the works of Mises and Wicksteed while compellingly arguing that economic theory was indeed "based upon reality," as Menger had originally claimed (Robbins 1969, pp. xv–xvi). Robbins's book quickly succeeded in demonstrating to most of the profession that the Mengerian method of formulating economic theory was both obvious and realistic. As Robbins (1969, p. 78) characterized this method:

> The propositions of economic theory, like all scientific theory, are obviously deductions from a series of postulates. And the chief of these postulates are all assumptions involving in some way simple and indisputable facts of experience relating to the way in which the scarcity of goods which is the subject matter of our science actually shows itself in the world of reality.[32]

By the mid-1930s, however, Robbins had begun to fall under the sway of Hayek and Hicks, conflating the dynamic Menger–Wicksteed price analysis with the Walrasian pure logic of choice as the essence of economic theory.[33] For example, in the syllabus for his course on "General Principles of Economic Analysis" given during the 1934–35 session, Robbins included under the heading "Modern works in general

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[30]Also, in appraising the economists who were at the LSE in the 1930s, Hayek referred to Hicks as "the super intellect," "wonderful theoretician," and "certainly . . . the best mind we had" (Hayek 1994, p. 87).

[31]For a good discussion of Robbins's early microeconomics papers, see O'Brien (1988, pp. 87–105).

[32]The central role that Robbins attributes to the concept of goods in the elaboration of economic theory was characteristically Mengerian. On this point see Salerno (1999).

[33]Robbins averred that once it was recognized at the LSE that Hicks's "was a mind of quite exceptional quality and grasp . . . his influence was pervasive" and "[w]e speedily acquired the habit of seeking his aid in solving analytical perplexities and his criticisms on our own propositions." Moreover, Robbins indicated that Hicks's influence at LSE "lasted long after his departure" and rated him as "one who must surely be placed in the topmost ranks of pure economists of the century" (Robbins 1971, pp. 129–30).

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theory" the treatises by Böhm-Bawerk, Wicksteed, Fetter, Clark, and Davenport alongside those of Cassel, Pareto, and the latter's follower, Enrico Barone. In a revealing note in the syllabus, Robbins wrote: "The treatment will be nonmathematical in character. Students who wish to witness the same problems treated mathematically should attend course no. 66 (Introduction to Mathematical Economics)" (McCormick 1992, pp. 31–32). For Robbins, evidently, the choice between the causal-realistic and the mechanical general-equilibrium approaches was now merely a matter of taste. Robbins's syllabus for 1938–39 evinced his further evolution away from the Mengerian tradition. Gone from the sections on general theory ("Statics" and "Comparative Statics") were the great Austro-American treatises of Clark, Fetter, and Davenport, while Pareto's treatise remained and Hicks and Allen's article on "A Reconsideration of the Theory of Value," Edgeworth's *Mathematical Psychics*, and Chamberlain's *Theory of Monopolistic Competition* were added. Moreover, while Wicksteed's treatise was listed as a prerequisite, Knight's *Risk, Uncertainty, and Profit* was now identified as the organizing text for the course.

Additional evidence of Robbins's drift away from the Mengerian camp can be found in the second edition of *Nature and Significance* published in 1935. In this edition, there are still numerous footnotes citing the works of Fetter, Davenport, Wicksteed, Mises, and Richard von Strigl, but now coexisting, somewhat incongruously, with footnote references to the works of Pareto and Hicks. Apparently this was not the case in the first edition. As Richard M. Ebeling, who compared the two editions, explains:

> The footnote references in this first edition show more clearly the strongly "Austrian" influence on Robbins's thinking than in the second edition of 1935, in which modifications in the text and deletions in and additions to the footnote references create the impression of different authorities having influenced his ideas. (Ebeling 1998, p. 1, n. 1)

Also, as Robbins significantly reveals in the Preface to the second edition, these changes were made under the "advice and criticism" of Hayek, Paul N. Rosenstein-Rodan and Alfred W. Stonier. Like Hayek, Rosenstein-Rodan was a member of the fourth generation and also a member of the Wieser-Mayer circle (Hennings 1997, p. 272). It is significant that in the Preface to the first edition of *Value and Capital*, Hicks also specifically mentioned Hayek and Rosenstein-Rodan, along with LSE general-equilibrium theorists Nicholas Kaldor, Abba Lerner and R.G.D. Allen, as contributing to the ideas underlying his own book (p. 273).

A brief word must here be said about the socialist calculation debate, because it starkly reveals the difference in approach between Mengerian price theorists like Mises, and verbal general-equilibrium theorists such as Hayek and the later Robbins. Both Hayek and Robbins in their critiques of socialist central planning emphasized the impracticality of the full and timely discovery by the central planning board of the widely dispersed knowledge needed to solve the system of simultaneous equations that were supposed to substitute for the monetary calculations of entrepreneurs. But for Mises, the economy was always in deep and fundamental disequilibrium and these equations were, therefore, completely irrelevant to the problem of economic calculation. Moreover, the problem of incomplete knowledge, especially due to ineradicable uncertainty of the future, was a problem that afflicted central planners and private entrepreneurs equally.

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While generally refraining from engaging in controversy with his fellow critics of socialism, Mises did explicitly address the differences between his own position and that of Hayek in an article published in a French economics journal in 1938. After arguing that the state of equilibrium describable by mathematical equations is a purely hypothetical, imaginary, and unrealizable future state whose conditions can never be known today and which "does not correspond to anything real," Mises wrote:

> Hayek, too, has shown that the application to economic calculation of the equations that describe the state of equilibrium presupposes knowledge of the future valuations of consumers. But in this he has seen only an increase of the difficulty of the practical application of those equations, instead of seeing a fundamental and insurmountable obstacle to their employment in economic calculation. It is of absolutely no importance at all that we envisage the socialist regime as a dictatorship with central planning, in which only the valuations of the dictator are relevant, rather than in the form of a community organized according to democratic principles in which the valuations of individual consumers or groups of consumers would be relevant to economic planning. The dictator too cannot know today how he will make his evaluations in the future when conditions will have changed; he cannot know it just as the individual consumer cannot know.[34]

Now, while it is true that important Austrian contributions to money, capital, and business-cycle theory continued to pour forth from the LSE throughout the 1930s, most from the pen of Hayek himself, they were progressively weakened by the fact that they were straying farther and farther afield from their roots in dynamic Mengerian price theory. The culmination of this unfortunate trend was Hayek's *The Pure Theory of Capital*, published in 1941, which was largely unsuccessful precisely because it was an attempt to reconstruct Böhm-Bawerkian capital theory on the basis of an intertemporal general equilibrium.

The last gasp of Mengerian price theory in its pre-Misesian incarnation actually occurred in the U.S. in the mid-1930s. Vernon A. Mund, a student of Fetter's at Princeton, published a monograph *Monopoly: A History and Theory* (1933), which was far superior to the Marshallian works on the subject published concurrently by Joan Robinson and Edward Chamberlain. Mund explicitly based his own analysis of monopoly on Menger's "new and unified analysis of monopoly and competition," which, he declared, "made Menger's work a signal contribution to economic theory." Two years later, there appeared posthumously Davenport's (1935) monumental—but stylistically opaque—dissection and critique of the entire system of Marshallian economics from the standpoint of causal-realistic price theory. Finally, in 1937, Fetter contributed four original chapters to a textbook on *Economic Principles and Problems,* edited by Walter E. Spahr. In retrospect, Fetter's eighty-five-page contribution represented the canonical statement of the core of Mengerian price theory as it stood immediately prior to Mises's reconstruction (Fetter 1937a,b,c,d). Needless to say, all of these works sank without a trace under the successive tidal waves of the Marshallian Imperfect Competition Revolution and the Hayek-Hicks reconstruction of general-equilibrium theory.

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[34]Mises (1938, p. 1059). The passage was translated into English by Jörg Guido Hülsmann and Joseph T. Salerno.

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Unresolved Problems within the Mengerian Paradigm

The fourth and final factor that contributed to the rapid dissolution of the Mengerian paradigm after World War I did not involve external circumstances, but analytical deficiencies internal to its theoretical approach. These shortcomings were twofold and tended to obscure the distinctiveness of the causal-realistic approach and to lead to a superficial, but widely accepted, characterization of it as a less rigorous, verbal version of the general-equilibrium approach. The first problem revolved around the concept of equilibrium. Menger had shown the importance of the concept of actually observable "points of rest" or momentary exchange equilibria in his analysis of the formation of real market prices. However, since Menger's *Principles* was intended as the general introduction for a prospective multi-volume treatise that he never wrote, he formulated the general principles of value-imputation for higher-order goods, but refrained from analyzing the pricing and allocation of the factors of production in an exchange economy. Hence, he had no need for the concept of long-run equilibrium of production.

Now Menger's concept of realizable exchange equilibrium is fully adequate for the analysis of the formation of actual moment-to-moment market prices and has remained the central analytical concept of causal-realistic price theory. Writing in 1910, Fetter emphatically affirmed that "The concept of the economic equilibrium . . . must be thought of as present in all dynamic societies . . . Any price, no matter how temporary or unstable, is one that for the moment brings into equilibrium the quantities bought and sold, produced and wanted at that price" (Fetter 1910, p. 133). Davenport coined the term "moving equilibrium" to designate the interdependent system of money prices that continually emerges from each moment's exchanges on the market. According to Davenport (1968, pp. 113–14), "Prices have their setting in a great moving equilibrium, all parts of which are related to all other parts and are in close interdependence with them." The actual, if momentary, equation of supply and demand that gives rise to a definite price in each individual market "assumes . . . an existing system of prices upon goods in general and an established price relation for these goods in terms of money." It is in this restricted, but crucial, sense that current-day Mengerians insist that the market is *always* in equilibrium.

Nevertheless, in order to trace out the causal relations that govern the complete and time-consuming adjustment of the structure of resource prices and allocations to given changes in the underlying data of the economy, the subsidiary and purely imaginary construct of a final equilibrium of prices and production is indispensable. This was recognized by Böhm-Bawerk, who employed the imaginary construct of a fully-adjusted, changeless economy in developing Menger's theory of imputation into a full-blown marginal productivity theory of factor pricing in a capital-using market economy (Böhm-Bawerk 1959, pp. 248–56). However, Böhm-Bawerk himself never explicitly identified or completely understood this method of imaginary construction. Unfortunately, still methodologically under the influence of John Stuart Mill, as was Menger also, Böhm-Bawerk erroneously maintained that it was merely "frictional obstacles" that prevented the real-world economy from instantaneously adjusting itself to this state of long-run equilibrium. While noting that "In actual practice such 'frictional obstacles' are infinite in number," Böhm-Bawerk disastrously conceded that if "perfection were attained" then the pricing and allocation of resources could be determined with "ideal mathematical accuracy." More disastrous still, Böhm-Bawerk argued that

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economic laws, such as the law of marginal productivity, would have "ideally complete validity" only in a world of undisturbed long-run equilibrium (pp. 255–56). Thus, Böhm-Bawerk's and Menger's methodology—i.e., the account they gave of the method they used to formulate economic theorems—was not only confused, but also incompatible with the actual method they employed in successfully formulating a causal-realistic price theory.[35]

The first economist to self-consciously identify and attempt a comprehensive explanation of the method that guided the Mengerian approach in theoretical research was John Bates Clark.[36] But terminological obscurity and internal inconsistencies marred even Clark's perceptive and pathbreaking discussion. Clark argued that the starting point of theorizing about the causal economic laws governing a market economy is the imagining of what he called a "static state." In this mental construct, the underlying data of the economic system are changeless and the pattern of prices and of resource allocation have been completely adjusted to these data, and, consequently, all product prices equal their average costs of production and entrepreneurial profits and losses are nonexistent. Clark (1965, p. 400) admitted that the depiction of such an economy is "completely imaginary" and that "a static society is an impossible one." However, he pointed out, using the static state in our reasoning is "a heroic but necessary application of the isolating method." This method permits us to analyze causal laws or "forces" which "[w]e always see . . . working in connection with other forces, but we have to imagine . . . working alone." Correcting Böhm-Bawerk and Menger, Clark thus affirmed without qualification that the "static laws" deduced with the aid of this imaginary construction are "nevertheless real laws . . . that still operate in the changing world of reality" (p. 30). Indeed, "static laws dominate the activities of a real and dynamic society" and the influences they exert on dynamic adjustment processes "are not imaginary; they are as real as anything on earth" (pp. 37, 401).

Clark thus had brilliantly and completely freed himself from Mill's harmful misconception that economic laws were only "hypothetically true," i.e., true in the absence of "disturbing causes," such as imperfect factor mobility or nonpecuniary motives for action. Unfortunately, Clark opened the door for another pernicious error with his choice of the term "static laws" to characterize the content of economic theorems. For these theorems are not about laws that apply in the timeless, changeless static state, which by Clark's own admission is "completely imaginary" and "impossible"; rather they are about the laws of the real, dynamic market economy

[35]For a critique of Menger and Böhm-Bawerk on this point, see Mises (1981, pp. 167–82).

[36]In the Preface to his great treatise, Clark (1965, pp. viii–ix) significantly remarked on the "resemblances and contrasts" between his theory and the theories of Menger, Wieser, and Böhm-Bawerk. In a letter written in 1890 to Menger's student, Robert Zuckerkandl, Clark was even more explicit about the affiliation between his ideas and those of the Austrians, writing: "Nothing gives me greater pleasure than to render full honor to the eminent thinkers, mainly Austrians, who were earlier in this field than myself, and who have carried their analysis to greater lengths" (quoted in Hayek 1992, p. 39). And later native Austrian economists certainly recognized Clark as one of their own. Mises, for example, remarked that "The ideas of the Austrian School were developed in the United States especially by John Bates Clark, founder of the renowned American School (Mises quoted in Greaves 1996, p. 50). And Hayek made the strong claim that "at least some of the members of the second or third generation of the Austrian school owed nearly as much to the teaching of J. B. Clark as to their immediate teachers" (Hayek 1992, p. 39). Finally, Fetter named Clark, rather than Walras, along with Menger and Jevons as "most fully representative of the three creative sources of the marginal theory" (Fetter 1923, p. 594).

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that unfolds in history. "Static law" is therefore a self-contradictory and confusing misnomer. Economic laws, in whose derivation the fiction of the static state is indispensable, are immutable *laws of reality* that govern human action and interaction in the irreversible flux of time; hence, they can have no application in the unrealizable static state where time and action are defined away.

The problems with Clark's discussion go beyond the merely semantic, however. Apparently confused by his own misleading terminology, he could not resist reifying the static state, implying that it has an independent and permanent existence—albeit one that is agitated by the never-ending "frictions and disturbances" associated with dynamic phenomena. For Clark, therefore, the static state exists in the same way that the level of the ocean really exists independently of the waves that continually roil its surface. In Clark's words,

> *The static state . . . should . . . be thought of as an ideal arrangement, projecting itself* through the disturbed and changing group system [i.e., competitive market economy] of actual society just as the imaginary level surface of the sea projects itself through the waves. [S]tatic society . . . is a shape and mode of action that the real world carries within it. . . . [W]e may grasp the essential reality of it. (Clark 1965, p. 402–03)

In accord with this reification, Clark divided economic theorems into propositions about "static forces" and "dynamic forces." Since both sets of forces are operating in the "world of fact," static economic theory must be supplemented by a theory of economic dynamics, i.e., "a science of economic friction and disturbance" (p. 32). Furthermore, the effects of the two sets of forces are not symmetrical: the static forces "at work in the unchanging world are not only working in the changeful one, but are even the dominant forces in it." As a result, despite the continual dynamic frictions and disturbances, real-world prices, wage rates and interest rates are "always comparatively near" to the "natural standards" set by static forces (p. 30).

Of course, Clark's lapse into fallacious concretizing of the static state should not obscure his brilliant achievement in demonstrating that the so-called "static method" is the one, true method of theoretical inquiry in economics. Nonetheless, Clark's preeminent position as "the first American theorist of international reputation" (Mai 1975, p. 51) ensured that his compelling but defective methodological account would have dire consequences.[37] For once, it is admitted that dynamic phenomena are secondary and that economic theory is basically a system of propositions about a virtually existing static world, the causal-realistic approach suddenly appears as a redundant and much less rigorous version of the general-equilibrium approach. And, as noted above, this is exactly how even its erstwhile supporters at the LSE treated it, after Hayek and Hicks began to introduce general-equilibrium economics to English-speaking economists in the 1930s.

As it encountered the theoretical developments of the 1930s, the Mengerian approach embodied a second, and even more fundamental, shortcoming. This was its failure to provide a theory of *money* prices and, therefore, of monetary calculation. Even in its most sophisticated variants, as found in the treatises of

[37] Mises himself, as late as 1933, employed Clark's distinction between statics and dynamics (although not precisely with the same meaning), even conceding that "In the present state of the science, it is not possible to determine whether dynamic laws are feasible within the system of catallactics" (Mises 1981, p. 108).

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Wicksteed, Fetter, and Davenport, it remained essentially a theory of a barter economy. While Menger and his followers keenly perceived that economic calculation could only operate with money prices and that a realistic theory of price must be a theory of a monetary-exchange economy, they were unable to overcome the seemingly irremediable split between monetary and value theory.

Menger himself identified the crucial difference between the money economy and the barter economy, pointing out that the quantitative comparison of the means and ends of economic activity facilitated by monetary calculation " is of the utmost practical importance, if not the basis and precondition for purposeful action," while "[i]n a barter economy the measurement of economic wealth and economic calculation are wrought with troublesome difficulties" (Zlabinger 1977, pp. 9–10). Menger also took the momentous first step in developing a theory of money prices by presenting a pioneering explanation of the demand for money in terms of individual desires for cash balances (pp. 32–40). Böhm-Bawerk, too, stressed that economic calculation must be monetary calculation, pointing out that "[m]oney furnishes . . . the neutral common denominator for the otherwise noncomparable needs and emotions of different individuals" (Böhm-Bawerk 1959, p. 250). Thus, his definitions of price always referred to money, and he continually emphasized the vital role of money prices in the process of "imputing" the subjective values of consumers upward from consumer goods through the ascending orders of capital goods to the original factors of land and labor. The factor prices thus determined through this monetary-imputation process permit entrepreneurs to compute and compare the costs of alternative production processes and to allocate scarce factors according to the law of marginal productivity. Böhm-Bawerk also conceived the opportunity cost of a commodity in terms of the marginal utility of its money price (*Geldgrenznutzen*) to the buyer (Böhm-Bawerk, 1962, pp. 351–70).

Based on similar insights, Wicksteed (1967, vol. 1, pp. 135–41; vol. 2, pp. 575–623, 768–69, 825–26) and Davenport (1968, pp. 254–331) both rejected the mechanical and aggregative quantity theory of money and attempted to develop a theory of money and money prices within the framework of the "micro" causal-realistic approach. Although they both made important progress toward this goal—and Wicksteed came very near to achieving it—their ultimate failure meant that Mengerian price theory still remained a theory of barter exchange. Now, it is true that Mises had made substantial progress in integrating monetary and value theory in his treatise on money (*Theorie des Geldes und der Unlaufsmittel* [*The Theory of Money and Credit*]) published in 1912. However, he had not elaborated the implications of this integration for price theory proper, and, as we shall see below, he himself considered this project unfinished until 1940.

Mengerian price theorists before 1940 thus lacked the analytical wherewithal to demonstrate that the timeless and moneyless general equilibrium approach and the unsystematic, partial-equilibrium Marshallian approach—the analytical pyrotechnics of the 1930s notwithstanding—were both plainly and profoundly irrelevant to the central problem of economic theory. This problem is to explain how monetary exchange gives rise to the processes of economic calculation that are essential to rational resource allocation in a dynamic world.

So, after a period of remarkable development and influence from 1871 to 1914, Mengerian price theory, the core doctrine of the Austrian School of economics, had

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stagnated and, by the mid-1930s, was virtually a closed chapter in the history of economic thought. It was not so much that the approach had been rejected but that—due partly to its own deficiencies—it had been uncomprehendingly conflated with competing approaches. Not surprisingly, given his central role in its accomplishment, this "fusion" of approaches and effective dissolution of the Austrian School in the 1930s was approvingly cited by Hayek in 1968 as evidence of the School's triumph. Implicating the entire fourth generation of the School, of which he himself was the most eminent member, Hayek wrote:

> But if this fourth generation in style of thinking and in interests still shows the Vienna tradition clearly, nonetheless it can hardly any longer be seen as a separate school in the sense of representing particular doctrines. A school has its greatest success when it ceases as such to exist because its leading ideals have become a part of the general dominant thinking. The Vienna school has to a great extent come to enjoy such a success. Its development has indeed led to a fusion of the thought stemming from Menger with that of [William Stanley] Jevons (by way of Philip H. Wicksteed), of Léon Walras (by way of Vilfredo Pareto), and especially, of the leading ideas of Alfred Marshall. (Hayek 1992, p. 52)

HUMAN ACTION AND THE REBIRTH OF THE MENGERIAN TRADITION

Mises must have been fully cognizant of this disastrous state of affairs when he immigrated to Switzerland in 1934. Comfortably ensconced as a fulltime, salaried faculty member at the Graduate Institute of International Studies in Geneva, Mises for the first time could fully focus his attention on academic research. Mises used this opportunity to write *Nationalökonomie*, the German-language predecessor of *Human Action* and a book that was intended to revive the Mengerian approach and elaborate it into a complete and unified system of economic theory.[38] As evidence of the importance that Mises attached to this book and of the time and energy he poured into it, he wrote very little else in the years leading up to its publication in 1940. Previously an enormously prolific writer, the extent of his output from 1934 to 1939 was comparatively meager: in addition to book reviews, short memos, newspaper and magazine articles, notes, and introductions, there was only one substantial article for an academic audience.[39]

In retrospectively describing his purpose in writing *Nationalökonomie*, Mises left no doubt that he sought to address the two burning issues left unresolved by his Mengerian forerunners: the status of the equilibrium construct and the bifurcation between monetary and value theory. Regarding the former, Mises wrote:

> I try in my treatise to consider the concept of static equilibrium as instrumental only and to make use of this purely hypothetical abstraction only as a means of approaching an understanding of a continuously changing world. It is one of the shortcomings of many economic theorists that they have forgotten the purpose underlying the introduction of this hypothetical concept into our analysis. We cannot do without this

[38] Mises indicated that he had long been dissatisfied with the price theory of Menger and Böhm-Bawerk, but only by the early 1930s was he able to clearly articulate his objections (Mises 1978, pp. 59–60).

[39] See Mises (1993, pp. 41–45) for a listing of published and unpublished writings during these years.

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> notion of a world where there is no change; but we have to use it only for the purpose of studying changes and their consequences, that means for the study of risk and uncertainty and therefore of profits and losses. (Mises 1980, pp. 230–31)

Regarding his effort to incorporate money into the Mengerian theoretical system, Mises identified his immediate inspiration as his opponents in the socialist calculation debate of the 1930s. These economic theorists, under the influence of the general-equilibrium approach, advocated the mathematical solution to the problem of socialist calculation. As Mises argued:

> They failed to see the very first challenge: How can economic action that always consists of preferring and setting aside; that is, of making unequal valuations, be transformed into equal valuations, and the use of equations? Thus the socialists came up with the absurd recommendation of substituting equations of mathematical catallactics, depicting an image from which human action is eliminated, for the monetary calculation in the market economy. (Mises 1978, p. 112)

But without an adequate theory of monetary calculation, which ultimately rests upon a unified theory of a money-exchange economy, Mises realized that there could be no definitive refutation of the socialist position. Accordingly, Mises revealed:

> My *Nationalökonomie* finally afforded me the opportunity to present the problems of economic calculation in their full significance. . . . Only in the explanations offered in the third part of my *Nationalökonomie* did my theory of money achieve completion. Thus I accomplished the project that had presented itself to me thirty-five years earlier. I had merged the theory of indirect exchange with that of direct exchange into a coherent system of human action. (Ibid.)

Thus, *Nationalökonomie* marked the culmination of the Mengerian theoretical approach, and, in a real sense, the rebirth of the Austrian School of economics. The causal-realistic approach now had the great systematic treatise that it required in order to definitively distinguish it from the rival approaches to price theory. When one compared *Nationalökonomie* to the influential restatement of the general-equilibrium approach Hicks had achieved in *Value and Capital*—which represented a fusion of the Walras–Pareto with the Wieser–Schumpeter traditions—the fundamental and irreconcilable differences between the Mengerian and Walrasian approaches were at last starkly and unmistakably revealed.

Hayek's reaction to *Nationalökonomie* is indicative of the wide gulf separating Mises's Mengerian approach to economic theory from that of the fusionists of the fourth generation. Although his 1941 review was generally sympathetic to the work, Hayek is perplexed by the fact that Mises had been unaffected by "the general evolution of our subject during the period over which his work extends [i.e., during the previous twenty to thirty years]" and that the development of Mises's thought during this period "appears to be decidedly autonomous." Hayek's bemusement stemmed from his failure to comprehend the fact that *Nationalökonomie* represented Mises's deliberate attempt to "autonomously" reconstruct a paradigm that could not be reconciled with the "general evolution" of economics in the direction of the Walrasian–Marshallian fusion of which Hayek himself approved. Particularly revealing is Hayek's prediction that the "central part" of the book, *viz.*, the sections on monetary calculation and catallactics, would not be

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its main interest to most readers. But, of course, these are precisely the sections that contain the substance of the reconstructed system of Mengerian economic theory (Hayek 1992, pp. 150–51).

With the Austrian school poised for a vigorous comeback on the strength of the publication of *Nationalökonomie* in early 1940, disaster struck. Cut off from the German-speaking market by the war in Europe, its Swiss publisher went out of business and the sale and distribution of Mises's treatise ceased. By the time the English-language edition was published by Yale University Press in 1949, the moment had passed for the immediate restoration of the influence of Mengerian price theory within the mainstream of economic theory. Leadership in pure theory had passed from Europe to the United States after the war, due to the migration of many Central European economists to America, combined with the enormous expansion of U.S. higher education faculties induced by the tuition subsidies created by the G. I. Bill (Barber 1970, p. 14). At the same time, intellectual currents were developing in the U.S. that led to a merging of the Marshallian and Walrasian approaches into an invincible orthodoxy.

Marshallian price theory in various forms had dominated the textbook literature and undergraduate teaching in the U.S. since the 1920s, but began to lose some of its luster by the late 1930s. By this time, economists began to perceive the limits of the Marshallian partial-equilibrium method that underlay the imperfect-competition revolution and, in works like Robert Triffin's *Monopolistic Competition and General Equilibrium Theory* (1940), attempts were made to incorporate it into general equilibrium theory. In the meantime, however, partial-equilibrium analysis had been transplanted to the Midwestern United States after World War I where it was expounded by Jacob Viner who had learned it from his Marshallian mentor, Taussig. The partial-equilibrium approach was absorbed by Viner's students at the University of Chicago along with Frank Knight's concept of perfect competition. The formal amalgamation of Marshall, Knight, and Viner, or "Chicago price theory" as it came to be called, was given its definitive statement in George Stigler's *The Theory of Competitive Price* published in 1942. Stigler's textbook, whose subsequent editions bore the title of *The Theory of Price*, was the precursor of and inspiration for the deluge of intermediate price-theory and microeconomics textbooks that were used to inculcate Marshallian partial-equilibrium price analysis into generations of American undergraduates in the postwar era. Needless to say, these books did not instruct their readers in the problems of monetary calculation or even alert them to their existence. [40]

There was a second, independent factor that produced a resurgence of interest in Marshallian price theory among American economists. Economists found their experience as policy advisers to the U.S. government during World

[40]See, for example, George Stigler (1965). "Money" does not appear once in the index of this book. In a more recent Chicago-style price theory text we find the following statement:

> Although prices and values are often given in terms of money, money has nothing essential to do with the analysis. . . . It is often asserted that economics is about money or that what is wrong with economics is that it only takes money into account. That is almost the opposite of the truth. While money does play an important role in a few areas of economics, such as the analysis of business cycles, price theory could be derived and explained in a pure barter economy without ever mentioning money. (Friedman 1990, pp. 100, 102–03)

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War II very agreeable and were eager to continue in this role in the postwar world. And given the problems of postwar reconstruction in Europe and Japan in the face of the looming Soviet threat and of the reconversion of the U.S. war economy to a peacetime footing, there certainly was a continuing demand for their services. More importantly, due to the inevitable "ratchet effect" that characterizes government expansion during crises such as the Great Depression and World War II, the U.S. government had permanently increased its scope of intervention into the American economy. It, therefore, now required a patina of scientific justification and guidance for its peacetime "economic management" functions that the economist as policy adviser was well suited to perform. But policy advising meant giving reasonably clearcut answers to the problems confronting policymakers. And for managing particular industries, markets and sectors, e.g., antitrust, labor, agriculture, and defense, partial-equilibrium models were made to order.

In the meanwhile, the American economics profession was evolving toward a technique-driven, journal-centered and positivistic "research" culture, and the formalizing and testing of partial-equilibrium models and their adaptation to particular problems served as grist for such research.[41] This culture also fueled interest in general-equilibrium analysis, which had secured a firm foothold in the U.S. economics profession with the publication of Samuelson's *Foundations of Economic Analysis* in 1947. Articles dealing with the problems of existence, uniqueness and stability of general equilibrium as well as with the application of the model to international trade and welfare economics quickly found their niche in the journals. These two research trends were eventually reflected in the peculiar fusion of Marshallian and Walrasian approaches found in almost all descendants of the Stigler intermediate price-theory text. Needless to say, in this era of arrant formalism there was no room for the causal-realistic price theory of Carl Menger.

This state of affairs was recognized and summed up by the editor of a collection of readings in price theory in 1971:

> The shades of Jevons, Menger, Edgeworth, Wicksteed, Wicksell, Clark, and Fisher may justifiably be offended by the attribution of modern price theory to two sources, Alfred Marshall and Léon Walras, but these two scholars have had far and away the most influence on twentieth century thought. . . . In contrast with Marshall's down-to-earth struggle with the interpretation of the detailed working of the economy stands Walras's grand construction of general equilibrium. In a typical British or American textbook on price theory nine-tenths of the contents stem from Marshall's work, general equilibrium only getting notice in a last chapter or appendix. (Townsend 1971, p. 57)

One need only add that the shades of Menger and Wicksteed at least (Clark lived until 1938) would have been feeling very restless by the 1930s.

This discussion suggests a revisionist thesis regarding the main reason why the influence of Austrian economics, seemingly at its international peak in the mid-1930s, should have declined so precipitously that, arguably, by 1940—and certainly by the end of World War II—it was absolutely nil. The conventional view is that Austrian economics was buried by the "Keynesian avalanche." But this is only true if we acquiesce to the mistaken identification of the essence of Austrian economics as

[41] For evidence of this formalization, see Backhouse (1998, pp. 85–107).

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monetary and business cycle theory. In fact, the Cambridge cycle theories of Pigou and Robertson were submerged along with the Austrian theory, while Marshallian imperfect competition theory not only survived, but has continued to flourish down to this very day. Similarly, Chicago price theory and Wicksell's and Cassel's general-equilibrium analyses endured the foundering of the Fisherian quantity theory and the Stockholm School's monetary "sequence analysis," respectively.[42] No, causal-realistic price theory, the quintessence of Austrian economics, was not suddenly undone in its prime by the thunderous eruption of Keynesian macroeconomics in the mid-1930s in Great Britain. Rather, abandoned by almost all of its defenders while still in an immature state, it had begun to be silently usurped by a rival approach many years before in the land of its birth.

Returning to Mises's achievement, the writing of *Nationalökonomie*, then, was a profoundly lonely venture. By the late 1930s, Mises could count on no intellectual allies in his solitary quest to revive and perfect the Mengerian tradition. As Hayek approvingly noted, the Austrian School of economics was virtually a closed chapter in the history of economic thought as Mises toiled away in Geneva at the close of the 1930s. When the first fruits of his labors withered on the vine unattended by a world otherwise occupied, Mises persisted and delivered *Human Action* into a positively hostile and uncomprehending world almost a decade later. It was this great work that, however improbably, diverted the course of intellectual history by igniting the modern revival of research in the Mengerian paradigm that started in the early 1960s and has continued to flourish down to the present day. But an account of this chapter of the history of the Austrian School has yet to be written.

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[42] In developing their "dynamic method" of sequence analysis, the younger Swedes, such as Erik Lindahl, Gunnar Myrdal, and Erik Lundberg took as their point of departure Wicksell and Cassel's "static method" of analyzing the "stationary state" or general equilibrium (Hansson 1982, pp. 18–22). Cassel's version of general-equilibrium theory constituted the core of the Heckscher-Ohlin model of international trade, which generated a great deal of interest after World War II; and George Halm's exposition of the socialist calculation debate in his popular postwar textbook included an appendix on the Casselian system of equations (Caves 1967, pp. 23–57; and Halm 1960, pp. 320–28).

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EXCHANGE VERSUS POWER: TOWARD A PRAXEOLOGICAL RECONSTRUCTION OF SOCIOLOGY

KENNETH H. MACKINTOSH

> No reasonable man can contend that the relations between price and supply is in general, or in respect to certain commodities, constant. We know, on the contrary, that external phenomena affect different people in different ways, that the reactions of the same people to the same external events vary, and that it is not possible to assign individuals to classes of men reacting in the same way. . . . The mathematical economists . . . formulate equations and draw curves which are supposed to describe reality. In fact they describe only a hypothetical and unrealizable state of affairs.
>
> – Ludwig von Mises
> *Human Action: A Treatise on Economics* (p. 348)

> It is a great fault of symbolic pseudo-mathematical methods of formalizing a system of economic analysis . . . that they expressly assume strict independence between the factors involved and lose all their cogency and authority if this hypothesis is disallowed. . . . Too large a proportion of recent "mathematical" economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols.
>
> – John Maynard Keynes
> *The General Theory of Employment, Interest, and Money* (pp. 297–98)

The following is an attempt to unravel a major tangle in contemporary sociological theory and research. Sociologists tend to ignore the clear distinction between exchange and power in social life. This peculiarity by itself can account for a great deal of the victimization and exploitation sociologists ponder in their theoretical writings and purport to find in empirical research.

It will be argued here that the problem stems from two related but distinguishable branches. The first, which is taken up in section one, is an endemic confusion

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between positive and logical theory that goes beyond simple inadvertence. Sociologists seek a profundity and seriousness in their work that belies the constraints entailed in any consistent theoretical perspective. Switching implicitly, and perhaps unconsciously, from one paradigm to another provides an illusion of scope which, though it may be within the legitimate reach of the social philosopher,[1] is clearly out of the grasp of a social science. There can be no objection to social philosophy when it is clearly identified, but when it is put in the place of a logically consistent mode of *analysis*—or of *understanding*—it works a sleight-of-hand that would convince the unwary that the latter has been fairly derived from the former.

Section two focuses on the other branch, which is the sociological concept of "unequal exchange." Sociologists in the main have never accepted exchange on a purely conceptual level. What they view as exchange in social life has been defined so broadly as to encompass virtually the universe of interaction itself. Unmistakable signs of the resort to coercion by a party to social interaction can thus be construed by the sociologists as evidence of an inequity inherent in exchange. Robbery at gunpoint can be described in the language of social exchange, simply by changing *or* to *for* in the imperative command, "Your money *or* your life!" It is in this way that one can portray even the most personal interactions as essentially political acts. As we have heard it repeated monotonously since the 1960s, marriage is political and sex is the purest manifestation of power.

The major implications of these theoretical oddities, as outlined in the first two sections, provide the substance of section three. Concerns here are focused first on the dangers inherent in sociological confusions between voluntary exchange and coercion and, second, on the manner in which sociology might be most easily reoriented. The discussion is carried over briefly into a fourth and concluding section that addresses the longstanding difficulties sociologists have experienced in coming to grips with the phenomenon of change.

A smattering of remarks pertaining to the recent historical context of the ideas unfolded herein has been included to accommodate readers for whom it may be unfamiliar. In no sense, however, can the following be taken as a study in the history of ideas. Despite the sharpness of criticism, it should be emphasized here at the outset that there is no reason to suspect the discipline would wither from the scene were sociologists to surrender their ideological beliefs. To the contrary, the social sciences provide an arena in which praxeology[2] can develop simultaneously along a number of divergent dimensions. By default, over the past generation or so, economists or the economically trained have taken over substantial portions of the work being done in history, political science, and sociology.[3] One may welcome or deplore this invasion of traditional turfs, as it were, but, if nothing else, it serves to demonstrate the intrinsic value of the various substantive divisions of

[1]Discussion in Shackle (1965, pp. 184–96).

[2]Defined by Mises (1976, p. xvi) as "the general theoretical science of human action."

[3]Most notably in history by Fogel (1989) and the "cliometricians," and in political science by Olson (1965), Buchanan, Tollison, and Tullock (1980) and the large numbers of scholars they have attracted. Becker (1957) led a charge directly into the mainstream of traditional sociological concerns by addressing racial and other forms of "discrimination" in a manner which ran directly counter to the received Marxian protocol.

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social reality. The work that can be accomplished in the sociological arena will prove inexhaustible.

POWER AND PARADIGMS

Introspection and observation conspire to suggest that *people employ means to achieve ends*. The most sophisticated among us have realized for some time[4] that the proposition can neither be proved logically, nor established empirically, but there is nothing between nature and artifice to stay us from recognizing it as a fundamental axiom of *action*. If we follow Rothbard (1962, p. xi) in adding a subsidiary postulate which establishes "a *variety* of human and natural resources," we will picture a world in which individuals choose from a variety of potential means in order to achieve a multiplicity of ends. Conversely, of course, one may assume instead that choice is illusory in the sense that means and ends have already been determined by some suprahuman agency; or empty because the pairing of means and ends is invariant, save for remediable ignorance and error; or powerless because the world is a chaotic place in which the relation between means and ends is utterly arbitrary.[5]

Disregarding the province of powerless choices on the grounds that it lies beyond anyone's measure of science, we are left with an action theory that incorporates choice and the deterministic realms of illusory and empty choice. For these latter, the varieties of natural and human resources appear as stimuli, one upon another, in patterned arrangements of such sensitivity and complexity as may defy complete scientific solution for an indefinite period. In the interim, terms like stimulus, cause, or independent variable can be used interchangeably. One could extend the list to include such words as "trigger," "exciter," or perhaps "coerce." The elimination of choice abolishes "action" in favor of "behavior," which, in turn, can be referred to as the dependent variable, the response, the effect, or even "compliance." Where choice is disallowed, nothing remains but cause and effect and special definitions of power become otiose.

Max Weber's apposite definition of political power (1921, pp. 52–56) is, therefore, an item of some theoretical importance to sociology, first in that he saw fit to provide it, but also by way of its universal currency and acceptance among sociological theorists and researchers. Political power, as Weber said, consists both in the monopolistic use of physical force by government to exact compliance from the citizenry, and, more importantly, because of the frequency with which it is used in everyday life, the credible threat that physical force will be availed if in the absence of timely compliance.[6]

Insofar as sociologists allude to power, coercion, compulsion, physical force, etc., they signal a commitment to the theory of action, which cannot then be shunted aside in favor of one variety of behavioral theory or another. This practice of inconsistency, so deeply ingrained in the discipline, has been defended by

[4]For a brief but nonetheless excellent nontechnical historical discussion of Western thinking on the vexed question of determinism versus free will, see Gardner (1983, pp. 100–15).

[5]Discussion in Shackle (1961, pp. 42–43).

[6]Because of its importance in human relations it would be well to append fraud to the category of physical force. It is undoubtedly correct to say that fraud which is not buttressed by force will eventually prove unsustainable, but over the shortterm it is coercive in and of itself.

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George Ritzer (1980), among many others, on the ground that sociology is a multiple paradigm science. Ritzer speaks volubly of a micro-macro continuum (1990, p. 347), while others describe the micro and macro as discrete yet co-valid perspectives (e.g., Blau 1977, p. 3).[7] Co-validity implies validity at the same moment in the sense indicated by the solution to a set of simultaneous equations—but this is out of the question. The systems of independent and dependent variables which are the fruit of a macro or positive methodology appear from the standpoint of logical theory as unanticipated outcomes of spontaneous individual actions (e.g., Hayek 1937). From an action perspective the positive laws amount only to spurious correlations which can be considered predictive only insofar as prevailing expectations and the interaction patterns which emerge from them remain as they have been. The independent variable of such systems appears to the action theorist as the reification of some set of unexamined relationships which are themselves dependent upon the circumstances of the moment and that can only be appended to theory in the form of special assumptions.[8] For the positivist, of course, action, with its paraphernalia of interactive choices, is no more than a clever trick that unenlightened men and women play on themselves. Logical and positive theories stand at the antipodes. Sociology may indeed abide as an affair of multiple paradigms, but they are not co-valid and the continuum is a creature of art.

Unlike politics, theory cannot flourish as an accommodation between rival perspectives. An academic discipline can certainly function as a big tent which tolerates competing viewpoints including even the hiatus of *positive explanation* versus *logical understanding* that has animated sociology for so many decades. The alternative of slurring this fundamental distinction, however, by means of recurring *ad hoc* references to continua and co-valid viewpoints is tantamount to obscurantism. It may seem reasonable to suppose that a social science can explain phenomena, on the one hand, while it develops a basis for the understanding of those same phenomena on the other, but this is an illusion. The phenomena are not the same. If social behavior can be explained via the axioms of positive science, the impulse toward *understanding* will evaporate. The very ideas of action, understanding, and choice will give way to the essentially meaningless laws of positive science.[9] The idea that the ultimate data of dualistic or pluralistic interpretations of experience can be traced back to a common source is a metaphysical interpretation rather than an assumption which could be any part of an experimental natural science (Mises 1962, pp. 117–20).

THE MYSTERIES OF EXCHANGE

Unfortunately Weber also used the term "power" in reference to an empirical probability that one individual might exact compliance from another by means of a frown, a gesture, or some other intimation of hope or displeasure not amounting

[7] Although the match is short of perfect, the sociologist's designations of micro and macro correspond respectively to the aforementioned categories of logical and positive theory.

[8] More than a generation past, it may be recalled, Lionel Robbins (1932, p. 114) complained that "not one single 'law' deserving of the name, not one quantitative generalization of permanent validity" had emerged from the efforts of the Historical and Institutional Schools over the course of a century. The most spectacular of recent failures may have been the quiet demise of the Samuelson and Solow (1960) version of the Phillips Curve which predicted well throughout the 1960s but reversed its slope as inflationary expectations spread through the population.

[9] Discussion in Mises (1976, pp. 1–67).

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to a coercive threat. The typical case is that of the person who accepts the unwanted suggestions of another in his or her own interest in maintaining or furthering a valued relationship. This is a straightforward interpersonal exchange which should be clearly distinguished from apprehensions of physical force. If the compliance is strictly onesided, which is to say that no advantage is sought by the donor, the action belongs in the category of "autistic exchange" wherein "the donor acquires the satisfaction which the better condition of the receiver gives to him" (Mises 1998, p. 196).

To whatever degree Weber may have sown confusion by using power as a term to designate compliance irrespective of its source, his contemporary Carl Menger fathomed the conceptual subtleties of interpersonal exchange with uncommon clarity. After more than a century his lucid discussion retains a freshness that can be appreciated by anyone newly approaching the subject. Menger recognized the powerful tendency to regard "the magnitude of price as the essential feature of an exchange." Given the obtrusiveness of prices in the exchange process and our ability to measure their magnitudes, he found it unremarkable that we tend to regard "the quantities of goods in an exchange as *equivalents*." Appearances to the contrary notwithstanding, any such commonsensical conclusion precipitates a confusion from which the mainstream of sociological thinkers have yet to emerge. "Commodities that are *equivalents in the objective sense of the term do not exist*—even on given markets and at a given point in time" (Carl Menger 1871, pp. 192–93; emphasis in original). What Menger said of *commodities*, of course, is predicable of the counters of any interpersonal exchange, but it is perhaps worth remarking on the ease with which a mistake stemming from the formal properties of money was carried over into nonmonetary exchange.

This is not the place to trace the recent history of the sociological conception of unequal exchange. It permeates the journals in which sociologists most commonly publish but it is seldom treated as the object of explicit discussion. During his rise to prominence within the ranks of sociological theoreticians, Alvin Gouldner stated matter-of-factly that *objective* value equivalence between "things exchanged" could be "measured by economists or other social scientists" (1960, p. 172). The absence of discussion supporting this remarkable assertion suggests that Gouldner simply accepted it as a portion of the received knowledge of social science. Speaking more generally, sociologists conceive the relative values of goods and services in a linear fashion which predates the concept of marginal utility.[10] They treat these relations as having been normatively established through a give and take of interpersonal exchanges between members of the sorts of definable groups characteristic of static agricultural or even preliterate societies. At bottom sociologists are suspicious of the notion that people exchange for mutual benefit. Evidently they languish in a mercantilist world where interpersonal exchange is a zero-sum affair that necessarily produces winners and losers at each encounter. Such a perspective creates "the need for a 'privileged point of view on the world,' of the intervention of an organ reckoned to be endowed with a 'superior' understanding, 'not spoilt' by interests" (Infantino 1998, p. 39).

[10]See, for example, Peter Blau's discussion (1964, pp. 174–75) of "exchange opportunity lines" which are said to represent a "fair rate of exchange." Ironically, he reports that "it may be, and often is, to the advantage of both parties to depart from the fair rate of exchange."

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Against the constraints of this mercantilist backdrop, the sociological mainstream has never challenged the categories of force and fraud. While power is recognized as physical force, however, it has been said to differ only in degree "from the power that rests on the supply of needed benefits" (Blau 1964, p. 125). Lurking just behind the dubious formulation of needed benefits, of course, is the idea that some few individuals will be able to dominate the lives of the many by their control of resources. Contra Mises (1927, p. 100), employment is seen as a favor which the enterpriser may bestow or withhold, respectively to the workers' salvation or ruin. The preoccupation of sociologists with public employment[11] has given rise to the idea that employers in general tend to pay wages which exceed their workers' marginal product—and this for the express purpose of reducing them to dependency. As Blau put it, "The more employees prefer their own job to any possible alternative, the more dependent are they on their employer and the more power does he have over them (Blau 1964, p. 120).[12]

With formulations like these, exploitation is worked into the very essence of the employment relation, not because of anything having to do with dispositions of surplus value, but simply because the sociologist wills it. Wages which are too low constitute "an exchange of things unequal in value" which is a core meaning of exploitation (1960, p. 166).[13] Wages which are too high, however, become exploitative by enabling one individual to coerce another. Lester Thurow (1973, p. 70) at least had the courage to say that a factor which "is paid more than its marginal product is an exploiter."

The sociologist's solution to this concocted dilemma of exploitation follows as if by logic and suffuses a vast literature which purports to quantify the inequities of market processes everywhere.[14] Implicitly or explicitly it calls forth a rigorous and unrelenting control of prices along with the qualities of goods and services which must ultimately reach into every corner of social existence.[15] In following this track sociology displays remarkable consonance with a Durkheimian impetus which has lasted now just over a century. Émile Durkheim's antipathy for the market is well documented[16] and provides for measures of control which answer precisely every contemporary complaint concerning putative inequality in the momentary results of market transactions.[17]

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[11]See Mises's discussion of wages and public employment (1946, p. 79).

[12]Blau's core notion informs contemporary discussions of the "wage premium," as found, for example in Halaby and Weakliem (1993).

[13]At this juncture Gouldner attempts to free "exploitation" from its strong association with ideological claims. He half-seriously proposes "reciprocity imbalance" as a substitute for exploitation, which he says is synonymous with "unequal exchange" (1960, p. 167). There is deep confusion here in that exploitation is not ideological for any who hold that value can be objectively measured.

[14]*The American Sociological Review*, which is the flagship journal of the American Sociological Association, has averaged better than one such publication per issue for many years. As long ago as 1982 the Association's guide to publication outlets for sociologists listed at least fifty-six journals as suitable vehicles for these interests (ASA 1982). Efforts to quantify, of course, are restricted to a subset of the econometric techniques of partial analysis.

[15]Discussion in Mises (1962, pp. 76–78).

[16]Excellent recent discussion in Infantino (1998, pp. 57–82).

[17]See, in particular, Durkheim (1960, pp. 111–27, 200–29; and 1897, pp. 361–92).

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Implications and Suggestions

Brushing aside all matters of paradigm and method, the problem for sociology is a plain inability to recognize coercion. If exchange is only a clever disguise for the credible threat of physical force we are left with the dismal task of finding the most congenial oppressor—with sociology to guide us in the quest, of course. At the point where sociology verges on one of the sundry varieties of twentieth-century Marxism, coercion is regarded as any stimulus or inducement to behave or act in a manner deemed inconsistent with "the objective laws of social development" (Weichert 1977, pp. 141–42). In this formulation, or course, whatever propaganda or physical compulsions are needed to insure compliance with objective laws cannot be viewed as coercive any more than we could describe the laws of physics as forces used against humanity at large or to benefit one individual, interest group, class, estate, caste, race, ethnicity, or gender over another.

Robert Fogel and Stanley Engerman (1974) suggested that classical liberals and socialists both have indulged in a myth in expecting coercion, up to and of course including slavery, to give way automatically, as it were, in the face of the tremendous efficiencies, respectively of market systems for the liberals, and for the socialists, scientific methods of production and control.[18] Experiences of the present century have provided a plentitude of evidence for the persistence of coercion in its most grisly manifestations.

An ideology which obscures the distinction between voluntary action and coercion is a dangerous instrument, and one which denies the distinction will ultimately prove deadly, irrespective of the original intentions of political leaders. In this specific regard there is nothing to choose between objective laws of social development and a collective conscience which stands "outside of and above individual locales and contingencies" (Durkheim 1915, p. 444) and forces "the individual to act in view of ends which are not strictly his own" (Durkheim 1893, p. 227). Both necessitate the emergence of a vanguard, a new class (Gouldner 1979), or other named privileged group "that is worth more than the rest of society" (Infantino 1998, p. 155)—to interpret the laws or the will of one metaphysical concoction or another.

The two branches of sociological confusion lately reviewed grow directly from a single root that Hayek (1946) labeled French or Continental conceptions of individualism—but has more lately been described as methodological collectivism. The sociological inability to conceive the categorical significance of voluntary action is virtually entailed in its preference for positive method. As noted above an overarching commitment to methodological collectivism is adroitly masked by the device of a continuum which sets out the individual and the collective as points in a single dimension. So long as this illogical continuum can be protected from criticism, the contentions of action theorists will continue to appear to the

[18] It should be noted that the action theorists cited herein have shown no susceptibility to this illusion. The point at issue is that full cognizance of coercion requires its clear separation from exchange, as such. The uncertainty of action virtually guarantees that individuals will enter into wholly voluntary transactions they live to regret, but no amount of *ex post* rationalization by injured parties or outside observers can derive coercion from the unforseen. The paradox is that outside observers who hold exchange to be coercive in and of itself will have little incentive to look for extraneous coercive elements in interactions which, at least superficially, give the appearance of exchange.

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sociologist as a congeries of selfserving claims mouthed by the propagandists of a propertied elite.

Pragmatically speaking, however, it may be the zero-sum penumbra of social exchange which is most readily open to critical exposure. Sociologists do not assert the complete onesidedness of every exchange but they are confounded by what they take to be the objective fact of a common lopsidedness in the distribution of benefits. One party to the exchange gets more than the other, or more than he or she would have been willing to take.[19] As a group, sociologists have never accepted the impossibility of making interpersonal utility comparisons and some have defended the practice as methodologically unobjectionable.[20] Resting just beneath this *cul-de-sac* is the implicit notion that individuals should have—or, better yet are *entitled to*—the substance of their most fleeting desires. Parenthetically, at least, the matter of entitlement can be read as a demand to know why, in a world of such incredible abundance "unmeasured by a previously established yardstick" (Marx 1859, cited in Hobsbawm 1964, pp. 84–85), anyone's wishes should go unfulfilled. Mises probably gave the clearest answer when he explained that "perfect satisfaction and its concomitant, the absence of any stimulus to change and actions, belong properly to the concept of a perfect being," which, as he recounted "is beyond the power of the human mind to conceive" (1976, p. 24). "[M]otorcars, television sets and refrigerators do not make a man happy" as Mises said. "In the instant in which he acquires them, he may feel happier than he did before. But as soon as some of his wishes are satisfied, new wishes spring up" (Mises 1956, p. 4).

Mises's logic cuts right across the grain of predictions that envision the replacement of consumers by beings who seek only to enhance their abilities as socialist producers,[21] and the Durkheimian necessity for a *collective conscience* to act as a brake on "excited appetites" which would otherwise "tend to exceed all limits" (Durkheim 1897, p. 383). As the condition for action *sans pareil*, dissatisfaction is not the odious thing that commonsense musing seems to suggest. Irrespective of any conscious intention, sociologists have cast about either for perfect beings or perfected slaves in fruitless efforts to spare humanity the trouble and irritation of having to act at all.

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[19]Sociologists who have been influenced by what is sometimes called a rational-choice or rational-action perspective tend to focus their attention on the latter of these. In a popular text written for introductory students Rodney Stark presents a variant of this idea as the sociological definition of exploitation, to wit, "All profits in an exchange in excess of the minimum amount needed to cause an exchange to occur" (1996, p. 699). Presently, this incomprehensible formulation is running in a seventh edition with no relief in sight.

[20]The late James Coleman (1990, pp. 769–84), for example, defended his decision to assume the position of the Hindu Brahmin who Robbins (1938) described as holding his own enjoyments and pains to be of infinitely greater magnitude than those of lower caste members. Coleman points out quite correctly that people make these kinds of comparisons quite readily and claims he too should be given this latitude so long as he refrains from rendering any social-welfare prescriptions. As a citizen, of course, Coleman was entitled to his values but he was obliged to surrender them at the threshold of theory.

[21]Richta, for example, encloses the word "consumption" in quotation marks while calling for scientifically based standards of nutrition, "the rational wardrobe," models of transport, housing, etc., calculated "to divert a maximum amount of resources to the development of human creative powers" (1969, pp. 167–69).

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The obstacles which stand most immediately in the way of a thoroughgoing reorientation of sociological theory and the research it must animate and constrain were surmounted in economics during the seventy years or so which followed the marginalist revolution. Initially the concept of marginal utility has to be understood and embraced, not simply as the appurtenance of some fictional realm of the economic man, but as predicate of human action in all of its manifestations.[22] With this accomplished it would no longer be possible to look at exchange from the distorting perspective of winners versus losers and the door would at least stand open to a modern understanding of interpersonal utility comparisons. From this vantage point methodological collectivism itself could be quietly dismissed without ever becoming the focus of a Kuhnian revolution (Kuhn 1962).

THE MALIGN NEGLECT OF SOCIAL CHANGE

Some forty years ago G.L.S. Shackle (1958, p. 105) achieved a great economy of expression in describing *predicted man* as less than human and *predicting man* as more. Ludwig Lachmann (1977, p. 88) quoted Shackle's proposition in a context of the market process but it applies with much greater urgency in the broader realm of praxeology. From time to time, in their exuberance to seize the mantle of predicting men and women, sociologists have claimed the capacity "to control man and his society" (e.g., Merton 1948, p. 210).[23] It would be a disservice to the discipline to suggest that these pretenses of the recent past have seriously intended the ramifications entailed therein.

The action theory which has been proposed as an alternative to this foolish dream opens up the much more satisfying prospect of understanding, at least to some limited degree, "the unanticipated consequences of purposive social action" (Merton 1936). That, of course, is the other side of sociology, promised by Professor Merton a dozen years before his impulse to control. Merton's efforts to bring this rich field of inquiry into the mainstream of sociological concern was gravely handicapped by his lack of attention to the seminal works of Menger, some fragments of which lay ready to hand in English translation (Menger 1892). Beyond that, however, his efforts, and those of his progeny, have been fundamentally thwarted by an imperfectly examined reliance on positive theory. Mandeville's (1728) concept of the unintentional order has haunted the fringes of sociology for more than sixty years.[24] Allowed into the mainstream, it would propel sociology in new and challenging directions, but it will remain in waiting for as long as methodological collectivism retains its sway in the discipline.

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[22]Infantino, who is a sociologist, rendered valuable service by explaining that the term economic action merely asserts that individuals operate in a pragmatic field seeking advantages for the sake of which they are willing to incur a variety of costs (1998, p. 39).

[23]This is a quotation from Robert Merton's essay "The Self-Fulfilling Prophecy" which was included in every edition of his *Social Theory and Social Structure*. Recently this fabulously successful treatise has appeared in German and French language editions.

[24]See Infantino (1998, pp. 83–99) for an excellent account of the narrow margin by which Durkheim himself failed to grasp the essential concept.

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THE COMMANDING HEIGHTS: THE BATTLE BETWEEN GOVERNMENT AND THE MARKETPLACE THAT IS REMAKING THE MODERN WORLD. BY DANIEL YERGIN AND JOSEPH STANISLAW. NEW YORK: SIMON AND SCHUSTER, 1998

Daniel Yergin's and Joseph Stanislaw's *The Commanding Heights* strives for breadth and perspective on an issue crucial to Austrian economics: the relative power of markets and governments. The authors have produced a book that is fundamentally optimistic that markets will continue to be the driving force behind world events, and that price decision-making will eventually prevail over political decision-making. From their experience analyzing interventionist forays into energy markets, they offer a compelling account of market expansionism and how the command economy lost its reputation.

While covering a broad philosophical spectrum, the book irons over divisions within market theory, but it honors a core Austrian principle. However, in the end, a lack of theoretical rigor, a thin presentation of intellectual history, and too many concessions to the values and priorities of the opponents of market freedom compromise their account.

Yergin is the Pulitzer-prize winning author of *The Prize*, the tale of the petroleum industry. Stanislaw is a Paris-based advisor to global companies, managing director of Cambridge Energy Research Associates. The title of the book is from Lenin's famous 1922 phrase declaring that markets should be limited and that government should manage the top levels of the economy. But over the last seventy years, the authors argue, the desire and ability of states to command these heights has shriveled. The great statist tide has turned during the course of complex interplay between government failures and market innovations. Notably, the turn of the last twenty years owes its torque to the public's changing beliefs about the capacity of states to solve social and economic problems.

In the 1980s, the push against command economies accelerated. In some cases, advocates of free enterprise simply landed unexpectedly in the command posts as if dropped behind enemy lines. Margaret Thatcher, the central heroine of the book, was essentially a free-market rebel in her party and a radical in her country. Even in other parts of the world, including Africa and Latin America where classical-liberal traditions are absent, the high ground was seized not for another group of compassionate thugs, but for privatization and freer markets.

Parts of this book are quite powerful. The story of Deng Xiaoping is fascinating. Following the Chinese Revolution of 1911, he was sent to France for further schooling. There, he developed two lasting passions, croissants and communism. "It was Ho Chi Minh, later the leader of North Vietnam, who would tell him where in Paris to get the best croissants" (p. 192). In 1979, Deng initiated an extraordinary set of

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reforms on practical grounds: "It doesn't matter whether a cat is black or white as long as it catches mice" (p. 195). In his challenge to the ideologically entrenched in his party, he suggested that they set up special leftist zones, with planning, rationing, travel restrictions, and a ban on foreign investment. Though Deng started the undoing of Communist Party economic hegemony, the authors concede that it is far from clear how his legacy will play out. Yergin and Stanislaw avoid any probing dissection of Deng's "sacred principle of pragmatism" and what that could mean for China's future.

Another feature of the book is the dozens of anecdotes connected with statist hubris. The most startling story comes not from the Soviet Union, as one might expect, but from India, and it concerns the Hindustan Fertilizer Plant built between 1971 and 1979 with public funds. Civil servants bought machinery from nine countries with financing from export credits. For a dozen years, twelve hundred employees clocked in every day. But during that time, the plant never produced any fertilizer for sale. The machinery did not fit together; yet everyone pretended, for twelve years, that the plant was operating.

One of the book's strengths is the dozens of original interviews of the major players, including Yegor Gaidar of Russia, Albert Fujimori of Peru, and Lawrence Summers, now deputy secretary of the Treasury, and formerly at the International Monetary Fund. The most readable chapter concerns Keith Joseph, Great Britain's "Minister of Thought," and Thatcher, who could not have forged Britain's U-turn without him. It is vivid and captures the sense of isolation that market advocates felt in the early 70s. It is amazing today to remember that a public figure could be easily demonized and shamed for introducing the basic lessons of Adam Smith and the insights of Hayek and Mises.

Superficiality corrodes the authors' account of the role of Austrian economics. Hayek's life and work is surveyed in slightly more than four pages. Like the Chicago School, the Austrian contribution is measured by the actual influence on people close to politics. We learn that Thatcher waved Hayek's *The Constitution of Liberty* in front of her party's "wets." We get a brief, but passable, explanation of the calculation problem, and that should suffice as a resounding plug for Mises's *Socialism*. Mises is less softhearted and more hardheaded toward socialist values than are Yergin and Stanislaw.

There are problems that cut too deeply, mortally wounding *The Commanding Heights* as the final word on the Great Turn. The first serious problem is the frequent reliance on conventional wisdom that turns out not to be true. Did Keynes save capitalism from itself, or was that a cliché that the authors are presenting? Did mixed economies deliver the goods, or is that an oversimplification that people believed, rightly or wrongly? Were laws passed to limit manipulation by robber barons, or was that mere perception (the question itself smuggles hidden premises)? Was capitalism's association with depression and war economically justifiable? When the authors drift between describing social perception and explaining economic history, they raise ambiguities.

The second problem is their basic framework, stressing that the world has moved from an era where it was believed that markets fail, to one where it is more often believed that government fails. The main issue is failure. They use the term so generally that it pertains to either efficiency or equity concerns or both.

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However, their conception of market success—never made explicit—resonates throughout their analysis. They believe, like many of the people who try to command the heights of the economy, that highly idealized competitive markets are the basis for analyzing real markets and for developing policies that will make real markets more like the ideal. Yergin and Stanislaw are far more Chicagoan than Austrian, far less inclined to follow the Misesian insight that the starting point of market analysis is the implication of human cognition and action, not mathematics.

Perfect competition is the foundation of their false ideal of market success. This is a preposterous theory made pernicious by its practice. There is no Wizard of Oz who has *special* market knowledge outside of those who are creating the market. The desire to grasp the levers and pulleys of the market to fix its allegedly inherent flaws is a gross pretense, almost always the expression of a desire for political discretion over economic outcomes. The standard of perfect competition and market success need not be met because it cannot be met.

The authors' failure to grasp the theoretical stakes leads them to a serious historical omission in *The Commanding Heights.* In another flagrant confusion of social perception, government propaganda, and tiddlywinks economics, they suggest that the Securities and Exchange Commission (SEC) was set up in the wake of the Depression to make the capital market work better (p. 52). Did it? Is there a difference between restoring confidence and artificially inducing overconfidence? We never find out. They are careful about recounting the SEC's origins, including the biography and personal foibles of its founder James Landis. But they don't follow through.

Fundamentally, the SEC regulates business speech to make the market *fair* for the little guy. Infatuated by the idea that no one stockholder should know more than any other, the SEC for years prevented them from meeting together. Then it enforced vigorously laws against people who knew more (the insiders) than others (the outsiders). It is immaterial to the SEC whether those insiders created that information. This agency made it a criminal act for a person who knows more than another to trade on that knowledge and make a profit. Thwarting efficiency in capital markets has its costs: the indiscriminate banning of insider trading; that is, using corporate property, is like a rule that forces corporations to toss money out of headquarters windows.

Yergin and Stansilaw note that change accelerated during the 1980s, but they do not even mention the farsighted and dominant agents of change: the leveraged buyout artists. In the eighties, entrepreneurs discovered gross bureaucratic inefficiencies in large firms. They found they could capture the value of underused assets by breaking apart diversified firms and consolidating lines of business. The leveraged buyouts (LBOs) inaugurated the era of "right-sizing" in the search for efficient organization. These entrepreneurs were unique in the world: there are no such dynamic corporate takeover markets in Europe and Asia. Entrepreneurs concentrated financial power and employed information that they themselves created to contest the incumbent management. LBO specialists like Kohlberg, Kravis, and Roberts used the innovative financing technique of high leverage with low-grade debt ("junk bonds") to buy underperforming firms. Entrepreneurs like T. Boone Pickens, using investment bank Drexel Burnham Lambert, could compete for the assets of a company by offering a stronger corporate vision.

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Whose side was the SEC on? It fought the perfectly legitimate activities of the capital markets, tooth and nail. It helped to turn Drexel's star, Michael Milken, into a political prisoner. Nearly every step of the way, the agency undermined the power of financial markets and promoted the increased bureaucratization of markets. The SEC was spurred on by Congress, flanked on one side by U.S. Attorney Rudolph Guiliani and on the other by sundry state legislators beholden to corporations in their district. The SEC sided with established interests, the Fortune 500, and its key constituency, the New York Stock Exchange. While their rationale for penalizing Drexel was to keep the markets fair for the little guy, in fact, its laws were purely protectionist.

In the power vacuum created when markets sucked the air out of government agency purpose, the SEC became reinvigorated by a Congress that wanted to focus the public on the "pressing national problem" of the hostile takeover market. In the end, people were put in jail (Michael Milken) and legitimate techniques vilified (like hostile takeover arbitrage—Ivan Boesky) because they violated the policy of perfect competition. Milken and others made the market fall short of its false ideal, by tipping the playing field, by upsetting expectations, concentrating market power. In fact, Drexel, the most successful investment bank of the 1980s, was punished for undermining establishment interests.

The third problem is their conception of the mixed economy, and where the most significant lines between market and government are drawn. Their account of financial market power is weak and leaves far too much of importance out of the picture. Their oil monomania blinds them. In 1973 and 1974, petroleum problems were certainly important and headline worthy. But the 40-percent drop in the value of the stock market triggered huge changes in the way risks are managed in the private sector. That was a turning point in the shift from strong managerial discretion (such as that found in the bureaucratic management of the large conglomerates) to strong owners by the mid-80s. The rise in the power of financial markets is incomprehensible without an explanation of the takeover and restructuring movement in the United States.

The authors' summary analysis of how state corporations function and then fail is very good. But, here again they miss an opportunity. They fail to apply those lessons fully to U.S.-style corporations with their web of state protections (charter, subsidy, and regulation) and buoyant community support. Yergin and Stanislaw don't like state corporations, but they seem content to live with disturbing compromises in corporate governance. They adopt a very conventional posture: they dislike unpopular, centralized, bureaucratic management. But they don't strongly criticize popular, decentralized, *constituency* influence (stakeholders) over private corporate decisions.

Their whole argument against state-corporatism seems to collapse at the end when they start sounding like former Labor Secretary Robert Reich. Yergin and Stanislaw obsessed, as many others are, with the problems of income inequality. Indeed, that is one of their critical tests of the new, free economies: will they spread the goods around *fairly*? Since it can't be done centrally, how might it be done noncentrally? They are vaguely sympathetic to the European view that world capital markets should not be driven by the "Anglo-Saxon cult of shareholder value," which would further divide the haves from the have-nots. They take several potshots at financial analysts who look to see if quarterly requirements are met.

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Either they do not find serious problems with the idea of expanding stakeholder power or they think that it is simply a political reality to which we must adapt. This is Deng's "principle of pragmatism" at work. The expansion of stakeholder power is simply a decentralized welfare-state program and is no less pernicious than the centralized federal expansion of rights and entitlements.

The fourth and last point is that they tell the story of the fight for economic freedom as bloodless. The fact is that some governments were not well-intentioned. In fact they were evil-intentioned. And where they were not explicitly venal, they were inspired by socialist values and it was those values that provided the bedrock of support for dictatorships all over the globe. No doubt there was interventionism that was public-spirited, yet naïve. But not nearly as much as they suggest.

The willingness to believe in the ideal of socialism can explain the massive self-blinding of the twentieth century. The horrors of dictatorships were evident—anyone could understand them. When Keith Joseph made speeches to students in the seventies, he was perceived as a Don Quixote. Exasperated, lonely, he would ask those students which countries ran their affairs better than Britain. The answers he got: Cuba, China, and Yugoslavia. Such staggering evasions of reality need a better explanation than the story recounted by Yergin and Stansilaw.

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THE SYNERGY TRAP: HOW COMPANIES LOSE THE ACQUISITION GAME. BY MARK L. SIROWER. NEW YORK: THE FREE PRESS, 1997

Two of the great economic phenomena of the end of the twentieth century are the bull market in stocks and the great national and international consolidation that has taken place in a wide variety of industries. While the collapse of communism, computer technology, and the Fed's easy money policy have been major contributors, the massive mergers and acquisitions movement has played a very direct role in both the bull market and this process of consolidation and economic development. Indeed, in each of the last several years, we have set new records for the largest single merger, the total number of mergers per year, and the total value of mergers.

Enter Mark Sirower, who asks the simple question, are mergers efficient? Do they really create synergy? And, ultimately, do they reward the shareholders of companies who make acquisitions through mergers? His surprising answer is, no. Mergers are not good for shareholders or, presumably, for the economy.

This corporate self-exploitation starts with the hefty stock-price premiums that companies pay to buy or merge with their "target" company. The author finds that this premium causes a loss to the acquirer's stockholders because the benefits of mergers, often labeled "synergy" are greatly overestimated. In addition, many mergers result in unforeseen difficulties that actually result in even worse stock performance.

While *The Synergy Trap* is a work in "management science," the author is not unfamiliar with economics. He writes knowingly about "economic rents," the competitive-market hypothesis, the winner's curse, and he uses competitive market forces as one of his prime arguments as to why many mergers don't work (because mergers alert competitors to changing competitive conditions and they do not sit still while the two firms merge). This, however, does not a good theory make and he provides little in the way of explaining why mergers fail to improve the lot of stockholders.

Ultimately, the author is led to an explanation of mergers based on economic irrationality. Company executives make "value-destroying acquisitions" as a form of gambling that has their own self-aggrandizement as its goal—"from a policy perspective . . . managers make these decisions *because they can*." He concludes that there are no mutual gains from exchange. The big capitalist is making irrational bets with the money of little stockholders and destroying billions of dollars of shareholder value in the process.

Why do big corporations pay so much more than you or I do for the stock of their target company? Simple, buying stock increases the demand and price of a stock. The typical small purchase has no perceptible impact on the price of a stock,

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but large block trades often have a noticeable positive or negative effect on the stock price. A merger is just a stock purchase on a much larger scale and, therefore, has a much more noticeable effect on price.

The key question that the author fails to ask here is, why is the company willing to pay top dollar on every share when it could buy so many shares at much lower prices on the stock market, and thus preserve a great deal of its own shareholder's value? Regulation causes this anomoly because it prevents companies from acquiring large blocks of stock in companies, without registering their intentions with the government and alerting the market to their intentions. The government protects these "target firms" from "hostile takeovers."

If mergers are so beneficial, why does the acquirer's stock price fall when mergers are announced? Mergers, like divestitures, put the market for a stock in disequilibrium. A merger can increase the supply if the target is purchased with the company's stock, or diminish the company's credit rating if purchased with debt or cash. Mergers can also affect demand if current shareholders find that the new merged company is no longer appropriate for their portfolios. A decrease in stock price for acquisition firms is, therefore, not irrational nor completely unexpected.

But why do *most* mergers destroy shareholder value? Here lies both the great problem and the great contribution of the book. The vast majority of mergers and acquisitions enhance shareholder wealth of both companies, but Mr. Sirower only looks at the 168 largest mergers of the 1980s. Other research has also shown that the larger the merger, the worse the stock price performance.

The largest companies are precisely the ones that are allowed the fewest opportunities to enhance shareholder value and are also the companies that come under the greatest antitrust scrutiny by government. If a large firm tries to grow too large, it can be accused of unfair trade practices, dumping, of trying to monopolize an industry. Large companies are also more likely to be prevented from expanding their business through vertical and horizontal integration because it might violate antitrust law. Likewise large companies are also more restricted from forming the most efficient mergers possible because such mergers might create too much *market power* or industry concentration.

While the author does not recognize these constraints on the companies in his sample, he claims that it would be cheaper for shareholders to simply buy shares of the target firm themselves, rather than through their company at such a big premium. This suggestion fails to recognize that such individual purchases would also increase the price, but more importantly, it neglects the fact that if the company were to distribute cash, shareholders would then immediately lose between one-quarter and two-fifths of their dividends to taxes. The high premiums paid to acquire new companies compares favorably to paying these taxes and paying taxes is much worse for society.

Mr. Sirower has done a great service in pointing out the anomaly concerning large-company mergers. While his own interpretation and policy conclusions are far off base, he has provided good evidence for the Austrian theory that antitrust policy is harmful to the competitive process and standard of living in society.

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INDIVIDUALISM IN MODERN THOUGHT: FROM ADAM SMITH TO HAYEK. BY LORENZO INFANTINO. LONDON AND NEW YORK: ROUTLEDGE, 1998

Professor Infantino has applied his considerable skills to the task of freeing the social sciences from the deforming constraints of methodological collectivism. Relying on the methodological individualism pioneered and developed by Bernard de Mandeville, Adam Smith, Herbert Spencer, Carl Menger, Ludwig von Mises, Friedrich Hayek and Karl Popper, Infantino renders a parsimonious statement of the theory of unintentional order. As a sociologist, he directs his colleagues to the similar themes that inform the writings of Georg Simmel and Max Weber in the larger context of his searching examinations of the constructivistic modes of thought so thoroughly ingrained in the major works of Émile Durkheim and Talcott Parsons.

Those who followed in the wake of Mandeville and Smith have made it possible to locate each of the major elements of unintentional order in these seminal writings. Therein, the human species is treated as social in its origins and constrained by what Infantino calls a "double-entry of account." Ego acting in view of his or her own interests depends upon means supplied by Others. To secure these means, Ego must supply material and services that are means to Others, used in furthering their own interests, which need not be approved by nor even known to Ego. Ego's own plan becomes a constituent part of a composition of individual actions that no one could have planned nor even imagined, *ex ante*.

Over his first three chapters, Infantino provides ample demonstration that the *social glue* that has been of such great concern to sociologists is clearly recognizable in the concessions individuals are bound to offer one another in the course of accumulating the means of their own satisfactions. These are the norms most relevant to the sociological enterprise. Arising directly out of interaction, they measure "the relationships which actually exist in society" (p. 17). The alternatives so prominently displayed in the mainstream of sociological theory and research are norms imposed by authority. At best, they measure relationships as imagined by an elite, which also seeks to bring them about.

In the case of economic exchange, norms appear in the form of prices. But if prices are merely the costs that individuals must accept to further their own action plans, they can be generalized to encompass all the accommodations and concessions individuals extend to others in social exchange—which itself is inclusive of all varieties of purely voluntary social interaction. Following a logical and painstaking argument, Infantino embellishes his thesis with the simple observation that "It is not by chance that Smith's 'invisible hand' was represented by a network of prices, and the 'impartial spectator' was constituted by a network of norms" (p. 163).

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In his endeavor to communicate effectively with sociological colleagues, Infantino has had to overcome a number of potential obstacles, some of which are merely historical and others more directly theoretical. On the historical side, he corrects the impression that Adam Smith found any substantive grounds for disagreement with Mandeville. Despite Smith's assertion that Mandeville's notions were "in almost every respect erroneous," Infantino has juxtaposed a sufficiency of passages from the works of both authors to establish their theoretical consistency. Turning more directly toward the theoretical, he dissolves the putative inconsistency between Smith's writings in *Moral Sentiments* and *Wealth of Nations* by demonstrating that "impartial spectator" and "invisible hand" coexist easily in the earlier work. Once the pretense of logical moral foundations has been rejected, as it was not only by Mandeville and Smith, but also by Hume, any fundamental distinction between the two ideas must vanish.

Sociologists should take a lively interest in this discussion, wherein they will appreciate the contours of C.H. Cooley's "looking glass self," G.H. Mead's "generalized other" and a neat sorting out of the social-scientific meaning that can properly be associated with the idea of "sympathy." Relying on Adam Smith (1976, pp. 158–59), Infantino suggests that sympathy merely allows us to see "ourselves as others see us or as they would see us if they knew everything about us" (p. 25). Nothing in the concept links sympathy to a sharing of values or goals. As he says, "sympathy is not a sentiment," and "putting oneself in the Other's place does not mean sharing his 'sentiments'; it is simply equivalent to adopting his observation post" (pp. 29–30). Those whose introduction to the history of social thought may have been slighted or forgotten should be impressed by the social psychological sophistication of these eighteenth-century writers. They insisted on the primacy of learning over "nature" and the utter importance of what we now call "primary socialization." However strongly contemporary sociologists and social psychologists may agree on these points, they appear hesitant to allow historical applications, which would eliminate the idea that human beings have depended at some critical point on the bequest of a societal template from some mysterious source or other.

On the theoretical side most directly, Infantino has been obliged to grapple with the sociological concept of unequal exchange. His treatment of this matter is excellent, but he may have underestimated the importance of the concept to many sociologists and the tenacity with which they embrace it. The mainstream of the sociological literature on inequality is grounded in one way or another on the possibility of unequal exchange. Infantino traces the basic idea to the mercantilists who held exchange to be a zero-sum proposition (p. 39). The theory of unintentional order, beginning with the ideas of specialization and the division of labor, depends fundamentally on an exchange process that is positive sum. It is equally clear that methodological collectivism depends just as heavily on mercantilist teachings, reworked as may be, into a neoclassical form that can be described as empirical at final equilibrium (e.g., Coleman 1990) or into a Durkheimian form wherein the values of an elite can stand proxy for the dictates of a *collective conscience* (e.g., Blau 1964). This is not the place to discuss the sociological affinity for the zero-sum game. Suffice it to say that Infantino has rested his case on absolutely solid ground. Exchange is an analytic concept that, by definition, excludes every element of force and fraud. Whether or not an absolutely pure

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exchange has ever been transacted between two human beings is clearly not an empirical question insofar as we are dealing with axioms; but the conceptual distinction is perfectly clear. In defense of the sociologists, it can be said that once *the actor* and *action* have been banished, Weber's distinction between class (market) and party (power) becomes meaningless and with it the distinction between exchange and coercion.

The ambivalence of sociologists to the presence of actors emerges as an important theme in the critical chapters that follow. The incorporation of choice leaves ample space for ignorance, error, force, and fraud; but the contrary does not hold. If choice is eliminated, nothing remains but stimulus and response. Notwithstanding the diminishing residuals of ignorance and error, it will no longer matter whether one says that responses have been triggered, elicited, induced, or coerced.

Durkheim is treated over two chapters that illustrate almost paradoxically how a thoroughgoing constructivistic cast of mind can be transformed—with only nominal changes—into a consistent statement of the cybernetics of unintentional order. Durkheim's most glaring deficit was his ignorance of the economics of his day. His polemics directed at economists, members of the "Orthodox School,"etc., are remarkable in their neglect of formal citation. Infantino quotes Bergson, who wrote that with Durkheim "one never encountered a fact" (quoted in Lukes 1972, p. 52). Infantino reveals Durkheim's strawman as none other than John Stuart Mill. This choice is remarkable in view of the avalanche of new ideas which animated the social sciences in the wake of a still recent marginalist revolution.

Durkheim's caricature of economists as positing "originally isolated and independent individuals, who consequently enter into relationship only to co-operate" (Durkheim 1964, p. 279) was irresponsibly false in 1893, but was carried forward nonetheless by Parsons and continues to this day to inform the sociological view of its own *raison d'etre*. The Durkheimian solution to a problem of order, which could not have been approached by the economists he imagined, was to cast the State as the supreme "organ of moral discipline" (Durkheim 1958, p. 72), making it an independent variable in the Hegelian manner (p. 63).

Durkheim never ventured into the arena of social origins. He was content merely to stress the impossibility that any such creature as *homo economicus* could have emerged to take on the task of societal architect. From this vantage point, he felt justified in arguing that society could only be a phenomenon *sui generis*. Infantino's explication of this troublesome concept focuses on Durkheim's decision to disallow by consideration the results of interaction by its principal parties in favor of a *real third person* upon whom these results became *crystallized*. This third person becomes the common sensorium that subordinates individuals to the common goals, which, in Durkheim's view, were necessary to society's existence (p. 75). In defense of the Open Society, here and in subsequent chapters, Infantino is only obliged to defend the proposition that human beings benefit (or suffer) from their own experiences. If this is true then the "privileged point of view on the world" must be that of a recognizable elite and not a reality *sui generis*. He places Durkheim's method in the larger context of collectivist thought, "with its conceit of defining the social Absolute" which will always be limited to "placing some individuals in an unjustified position of privilege" (p. 76).

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Infantino uses chapter 5 to draw out the detailed struggle between Durkheim's profound disdain for the market and his most genuine sociological insights. By carefully noting Durkheim's frequent lapses into methodological individualism, he is able to reconcile Durkheim both with Herbert Spencer and Georg Simmel. "The price to be paid" for this reconciliation "is the elimination of 'social realism,'" whereas "The advantages lie in the possibility of reaching a clear sociological method, and of throwing full light on the complex phenomenon that is unintentional order" (p. 98).

Chapter 6 documents the methodological individualism that had developed in sociology a generation before Talcott Parsons embarked upon a career that established his preeminence over a generation of sociological theoreticians. Infantino compares key writings of Carl Menger with those of Simmel and then examines the work of Max Weber aided by the critical eye of Ludwig von Mises. Following Menger, Simmel rejected the central thesis of historical realism—that "historical science is simply a mirror image of the event 'as it really happened'"—in favor of an a priori argument to which historians resort, if only implicitly, to arrange the "facts" into patterns of relief and background (Simmel 1977, pp. vii–viii and 76–77). With Menger he asserted the evolutionary origins of money as a tool capable of being put to a variety of unforeseeable uses. Simmel's contention that purely monetary obligations are those most congruent with personal freedom derives from the separation that money affords between services rendered and the goals that are privately pursued by actors. This opens our view to "a society that renounces a 'unitary' system of ends" (p. 114).

Max Weber treated sociology as *universal history* rather than as a social science "that aims at universally valid propositions" (Mises 1976, p. 106). Professor Infantino is thus obliged to reduce Weber's four-fold typology to the fundamental dichotomy of "value-rational" and "instrumentally rational" actions, on the way to presenting the ideas and insights that most evidently place him in the tradition of methodological individualism (p. 129).

Weber rejected "psychologism," arguing that sociology bears no closer relation to psychology than to any other science. He was among the first to derive declining marginal utility from the multiplicity of means and ends in the face of scarcity, independently of any physiological or psychological tendencies to satiation. Along with Boris Brutzkus and Mises, he grasped the importance of market prices for calculations that could approach any reasonable standard of economic efficiency. Most importantly, Weber insisted on the ultimacy of the individual in social action. For some cognitive purposes, entities such as associations, corporations, and states could "be treated as the subjects of rights and duties or as the performers of legally significant actions." But Weber immediately specified that "the subjective interpretation of action in sociological work" necessitated treatment of these collectivities "as solely the resultants and modes of organization of the particular acts of individual persons" (Weber 1978, p. 107). To acknowledge the particular acts of individual persons is to avoid the constructivist reification, which discovers them as mere emanations of the supraindividual.

Infantino's final substantive chapter is devoted to the early Parsons, introduced as an individual whose most basic impulses directed him to illuminate what he considered the necessarily moral foundations of human society by means of a

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sociology in which the *explanation* of social action could be found in its *justification* (pp. 158–59). Impressed perhaps by the startling successes of Mendeleev and others in the physical sciences, Parsons conceived a continuum for the sciences that began on the left, let us say, with the sciences of ultimate means such as physics and chemistry which deal with matter itself. Lying to the right of these sciences were those like engineering and economics which treat the relation between means and ends. On this basis Parsons felt competent to predict the science of "ultimate ends," i.e., sociology—awaiting discovery at the right extremity of the continuum. He failed to note that metaphysics is located to the left of physics, nor did he consider that his own creation might turn out to be of similar stuff.

Infantino documents Parsons's misreading of Spencer, his neglect of Simmel, and his embrace of Weber's failure, set out in the previous chapter, to grasp that individuals who pursue duty, honor, and beauty to the neglect of material gain those value the former more highly. Parsons was thus disposed to treat the voluntarism in his action theory as a species of submission to a transcendent normative order already outlined by Durkheim. Infantino notes Parsons's criticism that Durkheim's "individual" is a mere theoretical abstraction. As Parsons (1949, p. 355) said, this individual "is the fictional human being who has never entered into any social relationship." If the fictional human being is eliminated, however, we must protest with Professor Infantino that "society cannot be a *sui generis* reality, greater than the sum of its parts" (p. 152). Parsons was required at this juncture to choose between the concrete and the fictional actor—but he did not. Infantino finds the roots of this obstinate inconsistency in Parsons's moralism reinforced by a refusal to consider the unintended consequences of action.

The question of importance, both to citizens and theoreticians, is whether social order emerges from a network of conditions. If it does, there is no need for an imposed order of ultimate ends. On the other hand, of course, if the network of conditions is powerless, individuals are powerless to act freely on their own behalf and must be duly constrained. What Durkheim, Parsons, or any of us may perceive as a consistent collection of ends is, in reality, a collection of means embedded in the conditions we impose upon each other for their reciprocal appropriation. Action can thus be *explained*, as Infantino says, "by means of the personal objective of the actor, and it can be *justified* through socially accepted 'reasons', in which the 'conditions' imposed on Ego by the Other are reflected" in a "double-entry of account" (p. 159).

In concluding, Infantino summarizes the elements of any theory of intentional order as psychologism, the rational construction of preferences, and the idea that the results of social action can be conceived as a process of maximization (p. 169). Against these prescriptions he offers a view that, despite its venerable age, remains revolutionary. We learn to be selves after settling within ourselves the models, norms, and beliefs we have absorbed from the sociohistorical context into which we are born.

Those familiar with Professor Infantino's sources will be delighted by the efficient ease of his arguments. Others, who read with a critical eye, will appreciate his well-documented invitations to the seminal works which inform his views. Before adopting the term "praxeology" to designate the most fundamental of the sciences of human action, Ludwig von Mises had referred to this discipline as

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"sociology." In a few pages Dr. Infantino has demonstrated the sense and substance of Mises's earlier usage—both as to method and subject—for a sociology that can pursue the unlimited prospects of the unintentional order that inevitably emerges from purposive social action.

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